[2012] UKUT 320 (TCC)

Appeal numbers FTC/15/2011;
FTC/46/2011

Income Tax and NICs: scheme to deliver bonuses in form of shares avoiding income tax and NIC. S18(1) ITEPA Rule 2– whether employee became "entitled to payment" when amount of bonus determined. Ch 2 Part 7 ITEPA – whether shares were "restricted securities" within s 423(2)(c) – s 429 whether shares were in associated company: s416 control at general meeting level – sham: whether exculpatory provision in Articles a sham. **Ramsay-** ***whether on a broad Ramsay approach the scheme was outside Ch 2.***

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

UBS AG and
DB GROUP SERVICES (UK) LIMITED **Appellants**

- and -

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

TRIBUNAL: MR JUSTICE HENDERSON
MR CHARLES HELLIER
(TRIBUNAL JUDGES)

Sitting in public at The Rolls Building, Fetter Lane, London EC4A 1NL on 22, 23, 24, 27 and 28 February 2012

Mr Kevin Prosser QC, instructed by Pinsent Masons LLP, for UBS AG
Mr David Goy QC and Ms Nicola Shaw, instructed by Deloitte LLP, for DB Group Services (UK) Limited

Mr Paul Lasok QC and Ms Anneliese Blackwood, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. This is our decision on two appeals by the taxpayers from decisions of the First-tier Tribunal ("the FTT") (Dr David Williams and Mr David Earle) in favour of the Commissioners for HM Revenue and Customs ("HMRC") which we heard consecutively over five days at the end of February 2012. The appellant in the first case is UBS AG ("UBS"). The appellant in the second case is DB Group Services (UK) Limited ("DB"). Each case involved the use of a carefully planned tax avoidance scheme which was designed to enable the appellant bank to provide substantial bonuses to employees in the tax year 2003/04 in a way that would escape liability to both income tax and national insurance contributions ("NICs"). The mechanism chosen for this purpose was an award of redeemable shares in a special purpose offshore company set up to participate in the scheme. It was intended that the shares thus awarded to employees would be "restricted securities" subject to the special taxation regime contained in Chapter 2 of Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"), as recently inserted by the Finance Act 2003, Schedule 22 ("Chapter 2"). If the plan worked, the shares would escape taxation under the detailed and prescriptive provisions of Chapter 2, and the only tax to which they would potentially be subject in the hands of the employees would be capital gains tax ("CGT"). In practice, however, such liability was likely to be non-existent for non-UK domiciled employees, of whom there were a large number, provided they took care not to remit the proceeds of redemption of the shares to the UK; while for employees who were UK-domiciled, the scheme was structured so as to enable redemption to take place after the shares had been held by them for two years, by when (with the benefit of business taper relief) the rate of CGT chargeable would be only 10%, unless the employee had meanwhile left the bank's employment.

2. Since the top rate of income tax in 2003/04 was 40%, and since the shares, if taxable as earnings, would also have been subject to both primary and secondary Class 1 NICs (payable by the employee and the bank respectively), the fiscal attractions of the schemes, if they worked, were all too obvious. In broad terms, the position was succinctly summarised by the FTT in paragraph 134 of its decision in the UBS appeal:

   > "If the Scheme worked, both UBS and the individual employees derived significant benefit from it. UBS would pay the relevant bonuses into the Scheme without having to account to HMRC either for income tax or [NICs] for the employees or its own liability for [NICs] on earnings of employees. In global terms, it would need to put 100 into the Scheme and not 112, and the employees would receive 100 rather than 59".

3. The cases came before the FTT as appeals from determinations made by HMRC under the relevant PAYE and NIC regulations, on the footing that the

sums allocated to the employees as bonuses at the start of the scheme were liable to income tax under Part 7 of ITEPA (as earnings from their employment) and to Class 1 NICs (on the same basis). It has throughout been common ground that the position in relation to Class 1 NICs was for all practical purposes the same as the position in relation to income tax, with the result that no separate argument has been addressed to the NIC aspects of either case. Furthermore, since the employer was in each case obliged under the relevant regulations to deduct and account for any liability to PAYE income tax and Class 1 NICs on behalf of its employees, no separate determinations have been made against the employees involved, and the only appellants have therefore been UBS and DB. The FTT heard argument on, and decided, the points of principle which arose, leaving all issues of quantum in relation to individual employees to be decided later if necessary.

4. It is convenient to note at this point that, like the FTT, we will use the term "employee" to include office-holders such as directors, because the relevant legislation treats them alike.

5. The FTT heard DB's appeal over five days in February 2010, and UBS's appeal over a further five days later in the same month. Counsel for DB were David Goy QC and Nicola Shaw (also now QC), while Kevin Prosser QC appeared for UBS. Counsel for HMRC in each appeal were Paul Lasok QC, leading Mario Angiolini and Anneliese Blackwood. In the event, the FTT released separate decisions, first in the UBS appeal (on 6 August 2010, re-issued with corrections on 15 September 2010) and then in the DB appeal (on 19 January 2011). As the FTT explained in paragraphs 2 and 3 of the UBS decision, it had the benefit during the UBS hearing of the arguments which it had already heard in the DB appeal, and counsel for UBS had also attended part of the DB hearing. It was agreed that the FTT should take account of all the arguments in both cases in reaching its decisions, and that it would set out its full decision on the issues of law in only one decision, applying it as necessary to the other one (and also, in due course, to other cases raising similar issues which have been stayed while the present appeals were decided). The FTT chose UBS as the lead decision, having heard the fullest argument on it.

6. The FTT dismissed the bank's appeal in each case, but not for identical reasons because there were some important factual differences between the two schemes, which had been devised and implemented independently of each other and with different teams of professional advisers. In broad terms, however, the issues in each case can be grouped under three headings:

(1) First, did the employees become entitled to be paid their bonuses in money before the sums allocated to them were applied in acquiring scheme shares? If the answer to this question is yes, the bonuses were subject to income tax and NICs in the usual way, and the scheme failed because, if for no other reason, it came into operation too late: the tax

and NIC liabilities which it was designed to avoid would already have been triggered, and nothing in the schemes could remove those liabilities retrospectively.

(2) Secondly, assuming the answer to the first question to be no, and also assuming the provisions of Chapter 2 to be applicable, did any charge to tax arise in accordance with those provisions? In practice, this question involves consideration of two main technical issues: (a) were the scheme shares “restricted securities” within the meaning of the definition of that term in section 423 of ITEPA? And if so, (b) were the employees entitled to exemption under section 429 for the charge to tax that would otherwise admittedly have arisen under section 426 on the happening of a chargeable event when the shares ceased to be subject to the relevant restriction? In order for the scheme to succeed, each of those questions needs to be answered in the affirmative: in other words, the shares awarded to the employees had to be “restricted securities”, and the exemption under section 429 had to be available.

(3) Thirdly, and as an alternative to (2), can it be concluded, by application of the Ramsay principle as it is now to be understood, that on a realistic appraisal of the facts the scheme fell outside the scope of Chapter 2 altogether (rather than that the Ramsay principle affected the application of particular elements of the statutory regime) ?

7. In the UBS appeal, the FTT answered the first question in HMRC’s favour in relation to the guaranteed element of the bonuses of a small group of about ten employees, but subject thereto held that no entitlement to payment of cash bonuses had crystallised before the scheme was set in motion. Under our second heading, the FTT held that the scheme shares were not restricted securities, with the result that the scheme failed, but (if that conclusion was wrong) that the exemption under section 429 was available; or (in other words) that, subject to the global Ramsay argument, the scheme would have succeeded if the shares were indeed restricted securities. However, the FTT also held that HMRC succeeded on the Ramsay argument, so in its view the scheme failed on both broadly purposive and more narrowly technical grounds.

8. In the DB appeal, none of the employees had guaranteed amounts of bonus, and the FTT held, in line with its reasoning on the UBS appeal, that no entitlement to payment of bonuses had crystallised for any of the employees before the transfer of funds into the scheme. Under our second heading, the FTT held (on materially different facts from those in UBS) that the shares were restricted securities, and (again on materially different facts) that the section 429 exemption was available, so on a technical analysis the scheme succeeded. However, the FTT again held under the third head that the Ramsay argument succeeded, so the overall result was, once more, that the scheme failed.

9. On the appeals to the Upper Tribunal, brought with permission granted by the FTT, we heard argument first on the UBS appeal, followed immediately by argument on DB's appeal. DB's counsel and solicitors were present in court for the hearing of the UBS appeal, so duplication of argument was avoided. The representation of the parties was the same as before the FTT, save that Mr Angiolini no longer appeared for HMRC. We had the benefit of full and comprehensive written arguments, and of skilful oral submissions from Mr Prosser QC for UBS, Mr Goy QC for DB, and (in each appeal) Mr Lasok QC for HMRC. We express our gratitude to them all.

10. With this introduction, we propose to begin by examining the statutory scheme of Chapter 2 which the schemes sought to exploit. We will then deal in turn with the UBS appeal and the DB appeal, beginning with the facts and then considering the issues in the general order set out above. Although it might in some ways seem more logical to take the Ramsay argument before the technical arguments on Chapter 2, we consider it preferable to leave consideration of HMRC's global Ramsay challenge to the schemes until after the technical issues have been resolved. Apart from anything else, if the order were reversed we think there might be a danger of approaching the Ramsay issue at too high a level of generality.

The provisions of Chapter 2: background and context

11. Although the provisions of Chapter 2 are self-contained, they need to be seen in their historical context, and also in the wider context of Part 7 of ITEPA of which Chapter 2 forms part.

12. The historical context begins with the landmark decision of the House of Lords in Abbott v Philbin [1961] AC 352, when it was held (by a bare majority) that, where an employee is granted a share option by reason of his employment, income tax is charged on the realisable monetary value of the option at the date of its acquisition, and not on the value realised when the option is subsequently exercised. This principle applies even if the option is non-assignable or hedged around with conditions, so long as it is capable in some way of being turned to pecuniary account by the employee. Thus Lord Reid said at 376:

> "I can sum up my view by saying that conditions and restrictions attached to or inherent in an option may affect its value, but are only relevant on the question whether the option is a perquisite if they would in law or in practice effectively prevent the holder of the option from doing anything when he gets it which would turn it to pecuniary account".

So too Lord Radcliffe said at 379:

> "I think that the conferring of a right of this kind as an incident of service is a profit or perquisite which is taxable as such in the year of receipt, so long as the right itself can fairly be given a monetary value, and it is no more relevant for this purpose whether the option is

exercised or not in that year, than it would be if the advantage received were in the form of some tangible form of commercial property".

13. In practice, the tax liability on the grant of an option was often small or non-existent, because of the difficulty of putting more than a nominal value on option rights when they were granted, so it is not surprising that the Abbott v Philbin principle was soon reversed by legislation. Section 25 of the Finance Act 1966 (later consolidated as section 186 of the Income and Corporation Taxes Act 1970) imposed a charge to income tax on the exercise, assignment or release of employees' share options, on an amount equal to the gain thus realised, while removing any charge to tax on the grant of the option. Further refinements followed in 1972, whereby in certain circumstances a charge to tax could be levied on the grant of long-term share options, but at the same time (in recognition of the fact that share option schemes can perform a valuable social function) exemption from income tax was afforded to approved share option schemes, leaving the normal CGT rules to apply on any subsequent disposal of the shares.

14. The legislation which we have so far mentioned applied only to share options. It did not extend to what may loosely be called share incentive schemes, under which an employee subscribed for or was awarded shares to which restrictions were attached for a prescribed period (e.g. in relation to voting rights or the receipt of dividends), and which would become more valuable on the lifting of the restrictions. The Revenue appears to have taken the view that Abbott v Philbin did not apply when shares of this type were acquired, unless the amount subscribed for the shares was less than their market value at the time (in which case income tax would be charged in accordance with the decision of the House of Lords in Salmon v Weight (1935) 19 TC 174). Nor, until 1972, was there any specific charge to income tax when the restrictions on the shares were lifted. By section 79 of the Finance Act 1972, however, a charge to income tax was imposed on the appreciation in value of the shares at the end of a period defined by the earliest to happen of the lifting of the restrictions, the time when the employee ceased to have any beneficial interest in the shares, and the expiry of seven years from their acquisition. The assessment was made for the year in which the period ended. There were a number of exceptions from the charge, including one where (in broad terms) the shares were not subject to certain specified restrictions, and the majority of the available shares of the same class had been acquired otherwise than pursuant to a right or opportunity conferred on employees of the company (e.g. if the majority of the shares of the relevant class was owned by the public).

15. In essence, as we understand it, and subject to intermediate changes of detail which it is unnecessary for us to trace, these remained the broad contours of the income tax regime applicable to share options and share incentive schemes until 1998. By then the Revenue had received fresh legal advice, in relation to remuneration provided in the form of shares subject to forfeiture, to the effect

that the Abbott v Philbin principle applied and a charge to tax arose at the time when the shares were first awarded, on a value reduced by the risk of forfeiture. In a Budget press release issued on 17 March 1998, the Revenue explained the problem, and the proposed solution to it, which would have the effect of restoring the position, broadly speaking, to the Revenue's original understanding of the relevant tax rules. Thus there would normally be no charge to income tax on the employee when the shares were first awarded, but there would be a charge when the risk of forfeiture was lifted or, if sooner, when the shares were sold. As paragraph 9 of the press release made clear, a particular spur to remedial action was a perceived need to prevent tax avoidance:

> "By acting now, the Chancellor has also prevented schemes being specially set-up to exploit the new understanding of the tax rules. Had he not acted, the potential loss to the Exchequer would have been in excess of [£100 million]".

16. The Finance Act 1998 inserted new sections 140A to 140C into the Income and Corporation Taxes Act 1988 ("ICTA 1988"). As foreshadowed by the press release, the effect of these provisions was to remove the charge to tax in respect of the acquisition of conditional interests in shares, and to impose a new charge to tax on the market value of the shares when the condition fell away. Section 140C defined the cases where an interest in shares was to be treated as "only conditional". The general effect of the definition was that a beneficial interest in shares would be so treated for so long as there would be a transfer, reversion or forfeiture of the shares if certain circumstances either did, or did not, arise, and if the person entitled to the interest would then receive an amount less than the open market value of the shares in the absence of any provision for transfer, reversion or forfeiture: see section 140C(1).

17. Sections 140A to 140C of ICTA 1988 were re-enacted without amendment as the original Chapter 2 of ITEPA, but within a few months of the coming into force of that Act a new and much more complex Chapter 2 had been substituted by the Finance Act 2003. It is the substituted Chapter 2 with which the present cases are concerned. Before coming to those provisions, however, we first need to say a little about the broader context of Part 7 of ITEPA.

18. For this purpose, like the FTT in paragraphs [44] to [46] of its decision in UBS, we draw with gratitude on the authoritative exposition given by Lord Walker of Gestingthorpe JSC in paragraphs [3] to [7] of the introductory section of his judgment in Grays Timber Products Ltd v Revenue & Customs Commissioners [2010] UKSC 4, [2010] 1 WLR 497 ("Grays Timber"). That case concerned the ascertainment of the market value of employment-related securities for the purposes of Chapter 3D of ITEPA, which like Chapter 2 had been inserted by the Finance Act 2003. After explaining that Chapter 3D consisted of only three sections, which by comparison with other Chapters in

Part 7 (as amended) were "relatively simple and straightforward", Lord Walker continued as follows:

> "3. However Chapter 3D forms part of a complex code with fairly deep and tangled legislative roots. Many of the submissions made on behalf of Timber Products (which has been the appellant at every stage in these proceedings) relied on the need for the expression "market value" to be given a uniform meaning throughout the different Chapters comprised in Part 7 of ITEPA 2003. It is therefore appropriate to attempt at least an outline sketch of Chapter 3D's larger context, without going far into complexities which are not directly relevant.
>
> 4. Part 7 of ITEPA 2003 is headed: "Employment income: income and exemptions relating to securities". Its provisions reflect three different, and to some extent conflicting, legislative purposes. First there is Parliament's recognition that it is good for the economy, and for social cohesion, for employees to own shares in the company for which they work. Various forms of incentive schemes are therefore encouraged by favourable tax treatment (those in force in 2003 are covered in Chapters 6 to 9 inclusive of Part 7).
>
> 5. Second, if arrangements of this sort are to act as effective long-term incentives, the benefits which they confer have to be made contingent, in one way or another, on satisfactory performance. This creates a problem because it runs counter to the general principle that employee benefits are taxable as emoluments only if they can be converted into money, but that if convertible they should be taxed when first acquired. That principle was stated by Lord Radcliffe in *Abbott v Philbin* [1961] AC 352, 379 [*Lord Walker then quotes the passage which we have set out in paragraph 12 above*]. That was a case about share options, which are now dealt with separately in Chapter 5, but it illustrates the general approach that applied in the days when the taxation of employee benefits was very much simpler than it is now.
>
> 6. The principle of taxing an employee as soon as he received a right or opportunity which might or might not prove valuable to him, depending on future events, was an uncertain exercise which might turn out to be unfair either to the individual employee or to the public purse. At first the uncertainty was eased by extra-statutory concessions. But Parliament soon recognised that in many cases the only satisfactory solution was to wait and see, and to charge tax on some "chargeable event" (an expression which recurs throughout Part 7) either instead of, or in addition to, a charge on the employee's original acquisition of rights.
>
> 7. That inevitably led to opportunities for tax avoidance. The ingenuity of lawyers and accountants made full use of the "wait and see" principle embodied in these changes in order to find ways of avoiding

or reducing the tax charge on a chargeable event, which might be the occasion on which an employee's shares became freely disposable (Chapter 2) or the occasion of the exercise of conversion rights (Chapter 3). The third legislative purpose is to eliminate opportunities for unacceptable tax avoidance. Much of the complication of the provisions in Part 7 (and especially Chapters 3A, 3B, 3C and 3D) is directed to counteracting artificial tax avoidance. There is a further layer of complication in provisions which regulate the inevitable overlaps between different Chapters. It is regrettable that ITEPA 2003, which came into force on 6 April 2003 and was intended to rewrite income tax law (as affecting employment and pensions) in plain English, was almost at once overtaken by massive amendments which are in anything but plain English".

19. The only other reasoned judgment in Grays Timber was given by Lord Hope of Craighead DPSC, who in paragraph [56] made these observations about the broader context of Part 7:

"56. The provisions that are set out in the various Chapters that appear in Part 7 of ITEPA 2003 are complex, and it is not easy to draw conclusions as to how the charging provisions in each Chapter are to be applied if the overall aim is to achieve consistency. I am in any event not persuaded that it would be right to approach these provisions on the basis that the overriding consideration is that each Chapter should be applied consistently with all the others. As the commentator on the Finance Act 2003 in *Current Law Statutes* observed, if there is any theme in the Act it is one of anti-avoidance and the closing down of perceived tax loopholes. This suggests that the correct approach is to take each Chapter according to its own terms without trying to draw conclusions from the way the common definition of "market value" is applied elsewhere in Part 7. I would adopt that approach."

The detailed provisions of Chapter 2

20. Many of the key expressions used in Chapter 2 are defined in the introductory Chapter 1. Of particular importance are the definitions of "securities" in section 420(1) and (5), and of "employment-related securities" in section 421B(8) (which has to be read with the remainder of that section).

21. So far as material, section 420 provides as follows:

"**420 Meaning of "securities" etc**

(1) Subject to subsections (5) and (6), for the purposes of this Chapter and Chapters 2 to 5 the following are "securities" –

(a) shares in any body corporate (wherever incorporated) …,

(b) debentures, debenture stock, loan stock, bonds, certificates of deposit and other instruments creating or acknowledging indebtedness,

…

(5) The following are not "securities" for the purposes of this Chapter or Chapters 2 to 5 –

(a) cheques and other bills of exchange, bankers' drafts and letters of credit ..,

(b) money and statements showing balances on a current, deposit or savings account,

…"

22. Section 421B is headed "**Application of Chapters 2 to 4**", and relevantly provides as follows:

"(1) Subject as follows (and to any provision contained in Chapters 2 to 4) those Chapters apply to securities, or an interest in securities, acquired by a person where the right or opportunity to acquire the securities or interest is available by reason of an employment of that person or any other person.

(2) For the purposes of subsection (1) –

(a) securities are, or an interest in securities is, acquired at the time when the person acquiring the securities or interest becomes beneficially entitled to those securities or that interest (and not, if different, the time when the securities are, or interest is, conveyed or transferred) …

(3) A right or opportunity to acquire securities or an interest in securities made available by a person's employer … is to be regarded for the purposes of subsection (1) as available by reason of an employment of that person unless [*certain immaterial conditions apply*]

…

(8) In this Chapter and Chapters 2 to 4 –

"the acquisition", in relation to employment-related securities, means the acquisition of the employment-related securities pursuant to the right or opportunity available by reason of the employment,

> "the employment", in relation to employment-related securities, means the employment by reason of which the right or opportunity to acquire the employment-related securities is available …, and
>
> "employment-related securities" means securities or an interest in securities to which Chapters 2 to 4 apply …"

23. Chapter 1 also contains definitions of "market value" and "associated persons" to which we will need to refer in due course, but it will be more convenient to set out those definitions when we come to the relevant issues.

24. Chapter 2 itself is headed "Restricted securities", and section 422 sets out the scope of the Chapter:

> "422 **Application of this Chapter**
>
> This Chapter applies to employment-related securities if they are
>
> (a) restricted securities, or
>
> (b) a restricted interest in securities,
>
> at the time of the acquisition."

25. We are concerned only with restricted securities, which are relevantly defined in section 423 as follows:

> "423(1) For the purposes of this Chapter employment-related securities are restricted securities … if –
>
> (a) there is any contract, agreement, arrangement or condition which makes provision to which any of subsections (2) to (4) applies, and
>
> (b) the market value of the employment-related securities is less than it would be but for that provision.
>
> (2) This subsection applies to provision under which –
>
> (a) there will be a transfer, reversion or forfeiture of the employment-related securities … if certain circumstances arise or do not arise,
>
> (b) as a result of the transfer, reversion or forfeiture the person by whom the employment-related securities are held will cease to be beneficially entitled to the employment-related securities, and
>
> (c) that person will not be entitled on the transfer, reversion or forfeiture to receive in respect of the employment-related securities an amount of at least their market value (determined as if there were no provision for transfer, reversion or forfeiture) at the time of the transfer, reversion or forfeiture.

(3) …

(4) …”

26. In outline, section 425 then confers exemption from income tax in respect of the acquisition of restricted securities, provided they are restricted securities by virtue of section 423(2) and they will cease to be restricted securities within five years. However, it is open to the employer and the employee to elect within 14 days after the acquisition that the exemption is not to apply, in which case an Abbott v Philbin charge will arise.

27. The relevant provisions of section 425 are as follows:

> “425 **No charge in respect of acquisition in certain cases**
>
> (1) Subsection (2) applies if the employment-related securities –
>
> (a) are restricted securities … by virtue of subsection (2) of section 423 (provision for transfer, reversion or forfeiture) at the time of the acquisition, and
>
> (b) will cease to be restricted securities … by virtue of that subsection within 5 years after the acquisition …
>
> (2) No liability to income tax arises in respect of the acquisition, except as provided by [*certain immaterial provisions*].
>
> (3) But the employer and the employee may elect that subsection (2) is not to apply to the employment-related securities.
>
> [*Subsections (4) and (5) contain provisions about the making of such an election*].”

28. Section 426 then imposes a charge to tax on the occurrence of certain chargeable events. For present purposes the relevant chargeable event is that defined by section 427(3)(a) as:

> “the employment-related securities ceasing to be restricted securities … in circumstances in which an associated person is beneficially entitled to the employment-related securities after the event.”

The amount of the charge is ascertained by the application of complex formulae in section 428, the broad effect of which is to tax the market value of the securities immediately after the chargeable event “but for any restrictions”: see the definition of “UMV” in section 428(2). It should be noted that there may be more than one chargeable event in relation to an acquisition, and the sections provide for separately computed chargeable amounts on the happening of each such event. Thus even if a particular chargeable event is not, by reason of section 429, an occasion of a charge to tax, a later one may be.

29. The charge under section 426 is, however, disapplied in certain circumstances which are set out in section 429. The relevant provisions of section 429 are the following:

> "429 **Case outside charge under section 426**
>
> (1) Section 426 (charge on occurrence of chargeable event) does not apply if –
>
> (a) the employment-related securities are shares … in a company of a class,
>
> (b) the provision by virtue of which the employment-related securities are restricted securities … applies to all the company's shares of the class,
>
> (c) all the company's shares of the class (other than the employment-related securities) are affected by an event similar to that which is a chargeable event in relation to the employment-related securities, and
>
> (d) subsection (3) or (4) is satisfied.
>
> (2) For the purposes of subsection (1)(c) shares are affected by an event similar to that which is a chargeable event in relation to the employment-related securities –
>
> (a) in the case of a chargeable event within section 427(3)(a) (lifting of restrictions), if the provision mentioned in subsection (1)(b) ceases to apply to them,
>
> …
>
> (3) …
>
> (4) This subsection is satisfied if, immediately before that event, the majority of the company's shares of the class are not held by or for the benefit of any of the following –
>
> (a) employees of the company,
>
> (b) persons who are related to an employee of the company,
>
> (c) associated companies of the company,
>
> (d) employees of any associated company of the company, or

> (e) persons who are related to an employee of any such associated company.
>
> (5) …"

30. Quite apart from the exemption under section 429, it is also open to the employer and the employee to make an election under section 431(1) that "for the relevant tax purposes" (defined in section 431(3)) the market value of the employment-related securities at the time of their acquisition is to be calculated as if they were not restricted securities, and that sections 425 to 430 are not to apply to the securities. Any such election, like an election under section 425(3), must be made within 14 days after the acquisition of the shares. The effect of an election under section 431 is that, instead of the acquisition of the shares being exempt from charge, there is a charge to tax, for which purpose the market value of the restricted securities is to be calculated as if they were not restricted; but when the restriction falls away, there is then no charge at all under section 426.

31. The possibilities afforded by the rights of election in sections 425 and 431 are helpfully illustrated by Mr Prosser QC in paragraph 48 of his skeleton argument for UBS:

> "Thus, where an employer awards his employee shares which are liable to forfeiture, they have 14 days in which to choose between three alternative tax treatments. For example, suppose that at the time of acquisition, the unrestricted value of the shares is 100 and the restricted value is 50, and it is expected that if and when the risk of forfeiture falls away, the value of the shares will be 300. The employer and employee could (i) make no elections, in which case the acquisition will be exempt from charge by s.425, but there will instead be a charge on 300 if and when the risk of forfeiture falls away, under s.426 (subject however to the exemption from that charge under s.429 …); or (ii) make a s.431 election, in which case there will be a charge on acquisition, [on] 100, and no charge if and when the risk of forfeiture falls away; or (iii) make a s.425(3) election, in which case there will be a charge on acquisition, [on] 50 and (subject again to s.429) a charge if and when the risk of forfeiture falls away, [on] 300 x (100 – 50/100) = 150."

32. Finally, we should mention section 432 which contains definitions for the purposes of Chapter 2. For the most part, these definitions refer back to the definitions contained in Chapter 1, but it is material to note the definition of "restriction" in section 432(8):

> "(8) In this Chapter "restriction", in relation to securities …, means provision relating to the securities … which is made by any contract, agreement, arrangement or condition and to which any of subsections (2) to (4) of section 423 applies."

33. It is also worth noting, before we move on, that the exemption in section 429(1) and (4) had no counterpart in the simpler predecessor legislation of 1998. Where the new exemption applied, Parliament must have contemplated that the relevant restricted securities would escape any charge to income tax under Chapter 2 on that particular occasion, because the exemption in section 425 on acquisition of the securities would generally apply, and the charge under section 426 on the happening of a particular chargeable event would in turn be removed by the exemption in section 429. In such circumstances, Parliament must be taken to have intended that the only tax to which the shares would be subject in the hands of the employee would be CGT, unless a further chargeable event happened to occur. It is therefore impossible to start from the position that Parliament must have intended any award of restricted employment-related securities always to generate a charge to income tax under Chapter 2 either at the time of acquisition or on the happening of a chargeable event. The effect of section 429, where it applied, and there was only one possible chargeable event, was to leave the recipient of the restricted securities in the same favourable position as, for example, a recipient of shares under an approved share option scheme.

<u>UBS: The facts</u>

34. Before descending into detail, we will begin with the generalised outline of the operation of the scheme given by the FTT in paragraph [17] of its decision:

> "17. Generalising across this appeal and the other appeal heard by the tribunal, and in broad outline, the steps involved in the Scheme, as HMRC saw it, were as follows …
>
> (1) The Bank decided that it would give certain employees amounts by way of bonuses in addition to other earnings for the year. It was asserted by the Bank that this was done in such a way that the amounts did not constitute earnings of the employees.
>
> (2) Company Z was created in an offshore jurisdiction. Company Z was not controlled by the Bank.
>
> (3) A special class of shares was created in Company Z; the shares in that class ("the restricted shares") were subject to non-permanent restrictions.
>
> (4) The Bank – or another company or special purpose vehicle – purchased the restricted shares.
>
> (5) The purchaser received the restricted shares, passing legal title to a nominee, and allocated beneficial interests in the restricted shares to the employees identified at (1) in amounts equal in value to the amounts that the Bank had decided would be payable as bonuses to those employees.

(6) Exemption from a charge to tax on the acquisition of the beneficial interests in the restricted shares by those employees at step (5) was asserted under section 425 of ITEPA.

(7) A short while later, the restrictions were removed from the restricted shares. Exemption from a charge to tax on those employees on this event was asserted under section 429 of ITEPA.

(8) A further short while later, those employees became entitled to redeem their beneficial interests in the restricted shares. Arrangements were made so that the restricted shares could be redeemed by Company Z when timely applications were made. The redemptions took place at a value that was, or was contended to be, slightly less than the price paid by the Bank or special purpose vehicle for the restricted shares. Many employees redeemed their restricted shares at this time.

(9) Employees were entitled not to redeem their restricted shares on this occasion but, if they wished, could hold them in the Scheme for the two years necessary to mitigate a charge to capital gains tax. Some did so and then redeemed their restricted shares.

(10) A short while after the two year period ended, the rest of the shares that were previously restricted were redeemed at the initiative of Company Z, and Company Z ceased any activity.

(11) In due course Company Z was wound up."

35. The FTT heard oral evidence of fact from four employees of UBS at the relevant times. Geoffrey Hayward was a senior member of the bank's human resources team in London, who took part in the planning and delivery of the scheme. He was not involved in its detailed implementation. Jonathan Ferrara was the senior member of the bank's staff in Jersey, and became the UBS-nominated director of "Company Z", a Jersey-registered company called ESIP Limited ("ESIP"). He gave evidence of his involvement in that company's board meetings and the decisions which it took. Nicholas Anderson was in charge of the bank's tax department in the UK. He gave evidence about the planning and implementation of the scheme. Rebecca Jackson, who gave evidence by video-link from New York, was a member of the human resources team in London, and had a key role in the implementation of the scheme, although she had no decision making powers. While making due allowance for the difficulties of recalling events which had taken place some six years earlier, the FTT accepted the evidence of each of these witnesses, including their "honest attempts to answer, without any concealment or sidestepping, the challenges to their witness statements to the best of [their] recollection" (paragraph [58] of the decision).

36. The FTT also heard expert evidence, from David Bowes and Dr David Ellis for UBS, and from David Croft for HMRC. Mr Bowes gave evidence about the valuation of the shares in ESIP on 29 January 2004, while Dr Ellis gave evidence as an economist on the likelihood of the occurrence of the chosen trigger event (namely the level of the FTSE 100 Index exceeding a stated level between 29 January and 19 February 2004). Mr Croft also gave evidence on both those questions, as well as on the hedging arrangements using call options. The FTT recorded that "[h]e did so as an experienced businessman with direct experience in these issues" (paragraph [61]). Mr Croft was not a professional share valuer, but the FTT accepted that he had considerable practical expertise in dealing with share values and similar issues. Some of the comments in his report, however, went beyond the proper scope of expert evidence, and the FTT therefore excluded from its consideration any evidence of his that was "not directly focused on the questions of valuation at the relevant date, the trigger event, and the hedging arrangements" (ibid.).

37. The FTT was satisfied that all the key documents about the scheme had been put in evidence apart from communications with individual employees, of which the FTT was also satisfied that it had seen appropriate examples (paragraph [63]). The FTT annexed to its decision a "Chronology of events relevant to the appeal", running from 16 December 2003 to 30 June 2006, and recorded in paragraph [65] that the events listed in the chronology had occurred as therein stated.

38. Having set the scene in this way, the FTT did not proceed to make detailed findings of fact in chronological sequence, but rather made such further findings as it considered necessary when analysing the various issues. To a certain extent we will follow their example, but we think it will aid exposition, and promote clarity, if we provide a factual framework which puts some flesh on the bare bones of the chronology. None of what follows is intended to be controversial, or to go beyond the facts as found by, or accepted before, the FTT.

39. For several years UBS had operated a policy of making bonus awards to a number of its employees in or around February of each year, based on their performance in the preceding calendar year. Such bonuses were often paid in cash, in which case they attracted liability to income tax and NICs in the usual way as earnings from employment. Sometimes, however, schemes with perceived tax advantages were adopted, including a scheme known as ECAP which was a precursor to the ESIP scheme in the present case. Nothing turns on the ECAP scheme, save that the impetus to develop the ESIP scheme appears to have been the "unfavourable impact" of the Finance Act 2003 on the ECAP scheme. Discussion drafts of what became the ESIP scheme were already in circulation by late September 2003.

40. With the exception of the few employees who were guaranteed a minimum level of bonus, the entitlement of employees to receive a bonus was purely

discretionary. A typical provision, in a contract of employment dated 9 November 1998, was as follows:

> "**Discretionary Incentive Scheme**
>
> You are eligible to participate in the Bank's discretionary non-pensionable incentive scheme, which is in part dependent on both your own personal performance and on the Bank's results as a whole. Awards are based on the results for the calendar year. We must emphasise that whilst you are eligible to participate, this incentive scheme is wholly discretionary and should therefore not be treated as any form of guarantee or expectation. Any incentive award is always subject to your continued employment with the Bank at the date of payment, and neither you nor the Bank having served notice of termination of your employment at that time."

41. By November 2003 the general structure of the scheme had been finalised and a brochure was sent to employees explaining it and inviting their participation. The introduction to the brochure described ESIP as "a voluntary incentive opportunity for certain UBS employees in the UK". The "overview" explained that those eligible were executive and managing directors in the UK who were eligible for a 2003 discretionary incentive award, and that the maximum face value of an ESIP award would be 80% of any discretionary award, with a minimum of £20,000. The "Investment Vehicle" would be preference shares issued by the ESIP company, which would invest in UBS shares so that the value of a participant's shareholding would be indirectly linked to the UBS share price from the time that the investment was made. The "Vesting Period" was described as three weeks between 29 January and 19 February 2004, and there would be two redemption opportunities in March 2004 and March 2006 respectively. The intended fiscal outcome was "Capital Gains Tax Treatment". Employees were invited to express a preference by completing an online form by 12 December 2003, "following which UBS will exercise its sole discretion".

42. The brochure then explained in more detail:

> "**Preference Share Award**
>
> ESIP awards will be granted by UBS AG London Branch in the form of preference shares in an investment company incorporated outside the UK (the "ESIP Company"). UBS will own not less than 10% of the ordinary share capital of the company. The controlling ordinary shareholder of the company will be a third party trustee of an independent trust unconnected with UBS (currently expected to be Mourant & Co Trustees Limited). The terms of the preference shares will be laid down in the company's Articles of Association as negotiated between the ordinary shareholders. The description

contained in this brochure is based on discussions to date which have been held with Mourant.

In summary, the receipt of preference shares by ESIP participants will be subject to the following terms and restrictions:

Upon grant on the Award Date [29 January 2004], you will receive beneficial ownership of the preference shares;

The preference shares will be non-voting shares with an unrestricted market value ("Face Value") equal to the value of the 2003 Discretionary Incentive Award which might otherwise have been received in other forms;

During the Vesting Period, the preference shares will be subject to a Forced Sale Provision linked to the occurrence of a Trigger Event. This Forced Sale Provision will have the effect of depleting the market value of the shares during the Vesting Period (see further below).

Trigger Event

The Trigger Event will be an event that is outside the control of the ESIP Company, UBS and participants and that is objectively measurable. The proposed event is a specified aggregate rise in the closing level of the FTSE 100 index during the three week Vesting Period. The specified rise in the FTSE will be determined as being that increase which, based on accepted option pricing principles, has approximately between a 5% and 10% chance of occurring …

Investment Activities

On or around the Award Date … the ESIP Company will invest the proceeds arising from its issue of the preference shares in the following manner …:

- Approximately 97% of the proceeds will be invested on deposit; and
- Approximately 3% will be used to purchase call options over the FTSE 100 index (or other appropriate hedging instruments).

Should the Trigger Event occur during the three week Vesting Period ending on 19 February 2004, the following will happen:

- the ESIP Company will exercise its call options and realise a gain;
- the Forced Sale Provision will apply and participants' preference shares will be sold automatically for only 90% of

their Market Value. Market Value for these purposes means their unrestricted market value ignoring the effect of the Forced Sale Provision;

- taking into account any gain on the ESIP Company's exercise of its call options, the sale proceeds if the Forced Sale Provision applies are expected to be approximately equal to the original Face Value of the preference shares. These proceeds will be paid to participants as soon as administratively possible after March 31 2004.

Should the Trigger Event not occur within the three-week Vesting Period ending on 19 February 2004, the following will happen:

- the ESIP Awards will vest on that date, i.e. the preference shares will become completely unrestricted from that point onwards;

- on or around 20 February 2004, the ESIP Company will withdraw its deposit funds and use the proceeds (together with any option gain) to purchase UBS shares over a 5 day trading period from on or around 23 February 2004 to 27 February 2004. The value of each preference share will, subsequent to this investment, therefore be indirectly linked to the performance of the UBS share price."

43. Details were then given, under a heading in large type, of the first redemption opportunity in March 2004, and, under a heading in smaller type, of the "second and final redemption opportunity" in March 2006. In relation to dividends, it was explained that the ESIP company would receive dividends on the UBS shares which it owned, and that it was intended to distribute the net proceeds (after deduction of 35% Swiss withholding tax) to preference shareholders by way of dividend, after deduction of the company's expenses.

44. On 19 January 2004, ESIP was incorporated in Jersey.

45. On 23 January 2004, a remuneration committee of UBS finalised the list of employees who would receive an incentive award for 2003. Nothing was communicated to the employees at this stage.

46. On 26 January 2004, ESIP adopted new articles of association. Article 2(1) provided that the company should have an authorised share capital of £27,000, divided into 2.6 million 1p voting ordinary shares and 100,000 1p non-voting shares. We will refer to these classes as "the ordinary shares" and "the NVS" respectively. The remainder of article 2 then set out the rights and restrictions attaching to the ordinary shares and the NVS. The most important of these provisions are reproduced by the FTT in paragraph [89] of the decision. In bare summary:

(a) article 2(7) set out the rights of holders of the NVS to receive dividends and surplus assets on a winding-up, and to redeem all or any of their shares on 22 March 2004, 22 March 2006 or 22 June 2006 for the same amount as they would have received if there had been a winding-up on the relevant redemption date;

(b) article 2(14) contained the critical "forced sale provision" in relation to the NVS, to the effect that if the closing value of an index to be specified by the directors (who in due course specified the FTSE 100 Index) on any date between the date of first issue of the NVS (which was 28 January 2004) and 19 February 2004 ("the Restricted Period") was greater than a "Trigger Level" to be specified by the directors (who in due course specified 4,749.15) then the legal and beneficial interest in each NVS was to be immediately and automatically sold to the trustees of a discretionary trust for UBS employees, for a consideration equal to 90% of their "Market Value", defined as the price estimated in good faith by the directors to be obtainable on a sale of the NVS in the open market between a willing seller and a willing buyer, if no restrictions applied to the shares; and

(c) article 2(15) provided that, notwithstanding the previous provisions of article 2, at any time when the holder or beneficial owner of any NVS was UBS or any of its subsidiaries, the share would carry no right to dividends or other distributions, would only be entitled to receive par on a winding-up, and would not be redeemable.

The purpose of article 2(15) was to ensure that, during the short period when UBS held the NVS, its holding would not give it "control" of ESIP.

47. On 26 and 27 January 2004, 1,699,800 ordinary shares were issued by ESIP to Mourant & Co Trustees Limited ("Mourant") as trustee of a charitable trust established under Jersey law, called the Sidemore Trust, and 900,000 ordinary shares were issued to UBS. Thus UBS held over one third of the ordinary shares, which under Jersey law would have been sufficient to block a special resolution (for example, to wind up the company). UBS then gave 100 ordinary shares to UBS Employee Benefits Trust Limited, a Jersey company which acted as the sole corporate trustee of the UBS Employee Master Trust. This company was the nominated purchaser under the forced sale provisions in the articles of ESIP, and the purpose of the gift was presumably to bind it, as a shareholder, into the forced sale provisions.

48. On 28 January 2004, UBS subscribed £91.88 million for 91,880 NVS in ESIP (i.e. £1,000 per share). As conditions of the subscription, and in consideration of the sum of £1, the directors of ESIP agreed, among other things, (a) to specify the FTSE 100 Index for the purposes of article 2(14), (b) to set the Trigger Level at a value equal to 106.5% of the value of the Index on the date of acceptance of the subscription offer, (c) to apply up to 3% of the subscription monies in the purchase of call options over the Index with an expiry date of 20 February 2004, so that if the closing level of the Index

exceeded the Trigger Level on any date up to 19 February 2004, the company would realise a gain sufficient to ensure that the unrestricted market value of the NVS would be equal to approximately 110% of their original subscription price; (d) to invest the remainder of the proceeds of the subscription on deposit with a specified bank in Jersey until 20 February 2004; and (e) in the event that a forced sale of the NVS did not occur, to apply the money in the purchase of quoted ordinary shares in UBS on the secondary market over the last five trading days of February 2004, and to ensure that such shares should continue to represent substantially all of the company's net assets until 22 June 2006 (or such earlier date as the directors of ESIP should unanimously decide).

49. The object of the call option arrangements is helpfully explained by Mr Prosser in his skeleton argument:

> "19. The object of the call option arrangements was to ensure that, if the FTSE 100 Index increased to the Trigger Level, ESIP Limited would make a gain on the call options, thereby increasing its net assets by about 10%, so that although the employees would be required to sell their shares for 90% of market value, it would be 90% of a <u>higher</u> market value.
>
> 20. To take a simplified example of UBS subscribing £100 for ESIP shares, and awarding them to an employee: ESIP Limited paid £3 of the £100 to acquire call options, and so had assets of £97 plus the options. If the Trigger Level was reached, ESIP Limited would make option gains of say £13, and so would have assets of £110; the employee would be forced to sell his shares. The market value of the shares, determined as if there were no forced sale provision, would be £110, and so the forced sale price, which is 90% of market value, would be £99. If the Trigger Level was not reached, the options would lapse, and ESIP Limited would therefore have assets of £97; and the employee would be entitled to redeem his shares for £97 (subject always to the effect of any movement in the UBS share price … ESIP Limited was required to invest its assets in quoted UBS shares)."

50. On 28 January 2004 the FTSE 100 Index closed at 4,459.3, so the Trigger Level was fixed by the directors of ESIP at 4,749.15, representing a rise of 6.5%.

51. On 29 January 2004, a meeting of the UBS ESIP committee took place at which awards were made of 91,856 NVS to a total of 426 named employees. The remaining 24 NVS were allocated to the UBS Employee Master Trust. On the same day, letters were sent to the successful employees informing them of the face value of their ESIP awards, and saying that further information about the awards would be available from 9 February 2004. On 10 February, UBS informed the employees of the allocations of NVS which had been made to them on 29 January.

52. The FTSE 100 Index did not increase to the Trigger Level at any time in the Restricted Period, with the result that on 19 February 2004 the NVS ceased to be subject to the forced sale provision. Shortly thereafter, the subscription proceeds were duly invested in UBS shares.

53. On 22 March 2004, which was the first possible redemption date, about half of the NVS were redeemed at a price of £977.50 per share. Nearly all of the remaining NVS were redeemed in March and June 2006, for about £1,519 and £1,429 per share respectively, reflecting a substantial increase in the UBS share price between 2004 and 2006. In the meantime, dividends on the NVS had been paid of £13 per share in November 2004 and £20 per share in December 2005. The few NVS which had not been redeemed by June 2006 (consisting of the 24 shares held by the UBS Employee Master Trust and 20 held by an individual employee) were redeemed in November 2006, on ESIP's own initiative, when a resolution was passed to wind up the company.

<u>The money entitlement issues</u>

54. The basic question under this heading is whether any of the employees became entitled to payment of their bonuses in money *before* the sums which had been allocated to them within UBS were applied in the acquisition of, and the grant to them of beneficial interests in, the NVS. Resolution of this question does not depend on the provisions of Chapter 2, but on the application to the facts of the basic charge to income tax on earnings from employment.

55. In 2003/04, the relevant provisions for employees who were resident, ordinarily resident and domiciled in the UK were contained in sections 15, 18 and 19 of ITEPA, as follows:

> "15(1) This section applies to general earnings for a tax year in which the employee is resident, ordinarily resident and domiciled in the United Kingdom.
>
> (2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.
>
> …
>
> 18(1) General earnings consisting of money are to be treated for the purposes of this Chapter as received at the earliest of the following times –
>
> *Rule 1*
>
> The time when payment is made of or on account of the earnings.
>
> *Rule 2*

The time when a person becomes entitled to payment of or on account of the earnings.

…

19(1) General earnings not consisting of money are to be treated for the purposes of this Chapter as received at the following times.

…

(4) If subsection (2) or (3) does not apply, the earnings are to be treated as received at the time when the benefit is provided."

56. In relation to employees who were resident and ordinarily resident, but not domiciled, in the UK, materially identical provisions for earnings in the UK were contained in sections 21, 31 and 32 of ITEPA. In the discussion which follows we confine ourselves to employees who were resident, ordinarily resident and domiciled in the UK.

57. Leaving aside for the moment the broad Ramsay argument discussed in paragraph 162 below, it is clear that no payment of money was ever made to the employees in respect of their ESIP awards, so there can have been no receipt by them of money earnings within Rule 1 of section 18. HMRC argue, however, that the employees became "entitled to payment" of money earnings under Rule 2 when, at the latest, the list of incentive awards for 2003 was finalised by UBS on 23 January 2004. This argument was accepted by the FTT in relation to the minimum guaranteed amounts of bonus of the few (approximately 10) employees who had such an entitlement in their contracts of employment, but was rejected by the FTT in relation to all the other employees whose entitlement was purely discretionary, and also in relation to the non-guaranteed amounts of bonus paid to those with a guaranteed minimum.

58. We have already set out (in paragraph 40 above) a typical provision in the contracts of employment of those whose eligibility to participate in the incentive scheme was purely discretionary. For those who were guaranteed a minimum award, a typical contract of employment provided as follows:

"**Discretionary Performance Incentive Scheme:**

You are eligible to participate in the Bank's discretionary performance incentive scheme. The scheme is operated at the Bank's absolute discretion and may be amended or discontinued at any time. Participation in the scheme does not guarantee or give rise to a legitimate expectation of any entitlement.

…

Target Incentive:

> If you successfully achieve all your individual performance objectives as established by your manager, and if your business area and the Bank achieve their target financial objectives, for the calendar year 2003 you will be eligible to receive a discretionary target incentive award of [£]. This is not a guaranteed award. Consistent with the Bank's pay for performance compensation philosophy, your actual incentive award may be adjusted upwards or downwards, at the absolute discretion of the Bank, although in your case the actual incentive award for 2003 is guaranteed to be no less than [£]. This does not guarantee a minimum incentive for future years, or set an expectation for future incentive amounts.
>
> **Incentive Policy:**
>
> … The cash element of your incentive awards will be paid to you … in or about February following the calendar year specified in the awards ("the incentive payment date"), … You will not be eligible to receive your incentive awards if you or the Bank have served notice of termination prior to the incentive payment date. In the case of your guaranteed incentive award, you will be entitled to receive the award if your employment has terminated because of total disability, death, retirement or redundancy."

59. The FTT directed itself in paragraph [70] that the question was a general one, to be determined in accordance with general rules of contract and, if relevant, employment law. The FTT then set out the reasoning which led it to the conclusion which we have summarised:

> "71. The core of the argument for HMRC was that [UBS] must have allocated individual sums to employees as their entitlement to bonuses before the Scheme started. This was necessary because only certain individuals could subscribe to the Scheme. To be a subscribing employee, the employee had to have earned a minimum of £20,000 as a bonus for 2003. So the individual bonus entitlement of an employee had to have been determined before the individual could be allowed to enter the Scheme. And Mr Lasok contended on the evidence of the documents produced that this allocation occurred on 23 January 2004.
>
> 72. The Tribunal agrees with Mr Lasok QC that 23 January 2004 was when the relevant committee within [UBS] had agreed the list of those entitled. There was no evidence that any individual, once on the list, had been removed, or that anyone else had any discretion to remove anyone from the list or alter the amount any individual received. That is, however, not the relevant issue. The relevant issue is when the employee became entitled to be paid the bonus: see Rule 2 in section 18 of ITEPA.

73. The Tribunal saw in evidence information issued to employees at the relevant time, and correspondence between [UBS] and various individuals about their appointments to posts within [UBS], including examples of letters of appointment. It was informed of the other bonus systems run by [UBS]. It also saw the presentational material shown and distributed to employees about the Scheme and it heard the evidence of the witnesses. Subject to one point to which the Tribunal returns below, it is satisfied that the evidence gives a consistent clear picture that indicates that the employees were not entitled to, or to be paid, their bonuses until the February pay day, and it saw and heard no evidence to suggest that employees thought otherwise …

74. That finding applies to all relevant employees (said to number 426 in total) save for a small number, said to involve about 10 employees. These were employees who were appointed on terms that guaranteed them a bonus during the first year of appointment …

75. In these cases, the Tribunal finds that the terms of the letters it saw made it completely clear that the employee was entitled to the bonus identified not as a matter of discretion but as a matter of entitlement. That is the only natural and reasonable conclusion from the use of the phrase in the letters that the Tribunal saw …

[*Extracts from the letter are then set out*].

76. The first point that emerges from this is that an employee who receives a guaranteed bonus may also receive additional bonus. In so far as the bonus is in addition to the amount stated to be guaranteed, then the guarantee does not apply to it. Any additional amount must be considered in the same way as the full bonuses provided to those with no guarantee.

77. The second point is that the guarantee is just that, save for the limitation. It is to be received unless either the employee himself or herself serves notice to quit, or the employer serves notice for some reason other than the four reasons stated …

79. On that basis, the Tribunal finds and decides that once [UBS] had identified a specific sum as the bonus for 2003 for that individual, as it did on 23 January 2004, then to the extent that the sum identified was or included a guaranteed amount, the employee had an enforceable right to be paid that sum. It follows that it is then irrelevant for the purposes of Part 7 [of ITEPA] that the individual then decides to put his or her money into the Scheme, if the Scheme allows this to be done. The liability to pay income tax and [NICs] has already arisen …

82. More generally, the Tribunal finds that the evidence set out above about guaranteed bonuses is also evidence that these provisions were

> exceptional. The evidence further confirms the general finding of the Tribunal that in all other cases no bonuses were earned by employees before the start of the Scheme on 29 January 2004."

60. It can be seen that the core of the FTT's reasoning is to be found in paragraphs [73] and [79]: in the case of the employees whose participation in the bonus arrangements was purely discretionary, they had no entitlement to be paid their bonuses until the February 2004 pay day, but for those with an entitlement to a guaranteed amount of bonus, an enforceable right to be paid that sum arose on 23 January 2004.

61. At the heart of this part of the case is a question of construction which, although nowhere articulated in the decision of the FTT, was the subject of considerable debate before us. That question is whether the words "entitled to payment" in Rule 2 of section 18(1) denote only a present right to present payment, or whether they are wide enough to include a right to payment in the future (which may or may not be subject to defeasance or contingencies). UBS argues for the former interpretation, while HMRC argue for the latter. Surprising though it may seem, there appears to be no direct authority on the point.

62. In our view there are several powerful reasons which indicate that the former interpretation is correct.

63. In the first place, as Lord Hoffmann explained in <u>MacDonald v Dextra Accessories Ltd</u> [2005] UKHL 47, [2005] STC 1111 at [2] to [3], until 1989 the emoluments of an office or employment were taxed under Schedule E as income of the year of assessment in which they were earned, and it did not matter when they were paid. Section 37 of the Finance Act 1989 then inserted new sections 202A and 202B into ICTA 1988, and changed the basis of assessment under Schedule E from the year in which emoluments were earned to the year in which they were paid. In other words, the earnings basis of liability was replaced with a receipts basis. Section 202A(1)(a) provided that income tax should be charged under Schedule E "on the full amount of the emoluments received in the year in respect of the office or employment concerned", while subsection (2)(a) confirmed that this rule applied "whether the emoluments are for that year or for some other year of assessment". Section 202B then explained the meaning of "receipt", with paragraphs (a) and (b) of subsection (1) corresponding to what later became Rules 1 and 2 of section 18(1) of ITEPA. It seems to us inherently unlikely that, having chosen to depart from the earnings basis (under which earnings could be chargeable to tax in a tax year earlier than that in which they were received), Parliament should then have gone to the other extreme, and imposed liability to tax when the entitlement arose to a future payment which might not become payable until a subsequent tax year, and when the entitlement itself might be defeasible, or subject to conditions, in the meantime, as a result of which the future payment might in fact never materialise.

64. It is far more probable, in our view, that section 202B(1)(a), and later Rule 1 in section 18, were intended to lay down the basic rule that actual payment of the earnings was to be treated as receipt, while Rule 2 catered for the position where a present right to present payment of the earnings had accrued, but for whatever reason actual payment was delayed or withheld. It is easy to see the rationale for a limited provision of that nature, because a right to immediate payment would have crystallised, and in the absence of the rule it would be open to the parties to manipulate the timing of the receipt, and thus potentially the year in which it would be taxed and the rate of tax to which it would be subject, by the simple expedient of a delay in payment.

65. Secondly, by virtue of section 686(1) of ITEPA, the same rules are applied for PAYE purposes in ascertaining when a payment of, or on account of, PAYE income is to be treated as made, with a corresponding obligation on the employer to deduct and account for income tax on the payment. These rules may be expected to work without undue difficulty in relation to actual payments, or situations where a right to immediate payment has crystallised; but if it was intended to catch entitlements to future payments, perhaps in subsequent tax years, one would expect to find detailed machinery for that purpose, and provision to be made for cases where the entitlement never matured into an actual payment. No such machinery or provision, however, is to be found in the PAYE regulations.

66. Thirdly, if Rule 2 had the wide meaning for which HMRC now contend, it is hard to see what scope would be left for Rule 3, which (in broad terms) brings forward the deemed date of receipt in various circumstances where the employee is a director of a company, and the earnings are from employment with the company. Rule 3 provides as follows:

> "*Rule 3*
>
> If the employee is a director of a company and the earnings are from employment with the company (whether or not as director), whichever is the earliest of –
>
> (a) the time when sums on account of the earnings are credited in the company's accounts or records (whether or not there is any restriction on the right to draw the sums);
>
> (b) if the amount of the earnings for a period is determined by the end of the period, the time when the period ends;
>
> (c) if the amount of the earnings for a period is not determined until after the period is ended, the time when the amount is determined."

We find it difficult to envisage any circumstances in which these provisions would operate where an entitlement of some sort to the future payment of the earnings in question had not previously arisen; but in that case, on HMRC's interpretation, Rule 2 would already have been triggered, and Rule 3 would therefore be unnecessary.

67. Fourthly, there is high authority for the proposition that, if the terms of a definition are ambiguous, the choice of the term to be defined may throw some light on their meaning: see MacDonald v Dextra, *loc. cit.*, at [18] per Lord Hoffmann. Section 18 gives, in effect, a definition of "receipt" of earnings for the purposes of Chapter 4 of ITEPA. On UBS's interpretation, Rule 2 is only a slight extension of the natural meaning of receipt embodied in Rule 1, and its rationale is easy to understand; but on HMRC's interpretation, the accrual of an entitlement to a future payment is the very antithesis of receipt of such a payment, and there is no obvious explanation why Parliament should have wished to extend the basic charge to tax on receipts to cover such a situation, particularly given the acute practical difficulties which could be expected to arise. More generally, if (for example) a person agrees to accept employment for a period of two years at a fixed salary payable monthly in arrears, nobody would say that the full two years' salary was received by the employee at the date when the contract of employment was signed, and the employer would no doubt be startled to learn that it was expected to deduct and account for tax under PAYE on the full amount at that date.

68. Mr Lasok sought to derive some support for his argument from the decision of Lightman J in Pardoe v Entergy Power Development Corp [2002] STC 286, which concerned a little-used power in section 777 of ICTA 1988 for the Revenue to issue a direction for the deduction of basic rate tax from the consideration paid on certain transactions in land. By virtue of section 777(9), the power was exercisable if it appeared to the Board "that any person entitled to any consideration or other amount taxable under section 775 and 776 is not resident in the United Kingdom". In agreement with the Special Commissioners, Lightman J held that the Revenue could give such a direction if, and only if, at the time when they gave it they were satisfied that there was a present entitlement. They could not give a direction where there was only a prospect, however imminent, of future entitlement, nor could they give a direction intended to take effect in the future when an entitlement arose: see 295a-b. Mr Lasok relied on Lightman J's identification of the purpose of this provision as being "to provide some measure of protection to the Revenue where an entitlement has arisen to a taxable receipt: the Revenue are given power to intervene between the dates of entitlement to payment and of actual payment": see 294g. It seems to us, however, that the statutory context is too far removed from Schedule E and earnings from employment to provide any helpful guidance on the correct interpretation of Rule 2. Indeed, if anything the case seems to us to help UBS rather than HMRC, because at 294c-d Lightman J endorsed the proposition that:

> "[t]he phrase "any person entitled" in ordinary usage means "any person presently entitled" and does not embrace a person prospectively entitled if some event happens in the future."

69. For his part, Mr Prosser relied on the decision of the Court of Appeal in DTE Financial Services Ltd v Wilson [2001] EWCA Civ 455, [2001] STC 777, where Jonathan Parker LJ (with whom Sedley and Potter LJJ agreed) said at [42], accepting the submission of Mr Glick QC for the Crown recorded in [37], that:

> "in the context of the PAYE system the concept of payment is a practical, commercial concept. In some statutory contexts the concept of payment may (as Lord Hoffmann pointed out in *MacNiven*) include the discharge of the employer's obligation to the employee, but for the purposes of the PAYE system payment in my judgment ordinarily means actual payment: i.e. a transfer of cash or its equivalent."

70. We agree that this passage provides some support for UBS's argument, and we note that in the present case HMRC appear to be arguing for a much wider interpretation of Rule 2 than they did, in relation to the materially identical wording of section 203A(1)(b) of ICTA 1988, in DTE Financial Services v Wilson. Furthermore, the argument now advanced by HMRC appears to be at odds with the guidance given in paragraph 42290 of the Employment Income Manual, which states that Rule 2 is concerned with the date when a person becomes entitled to payment of earnings, which "is not necessarily the same as the date on which an employee acquires a right to be paid". The example is then given of an employee whose terms of service provide for him to receive a bonus for the year to 31 December 2004, payable on 30 June 2005 if he is still in the employer's service at the end of 2004. If the condition is satisfied, the employee becomes entitled to a payment on 31 December 2004, but is only entitled to payment of it on 30 June 2005: "So PAYE applies to it on 30 June 2005 and it is assessable for 2005/06. The date that matters is the date the employee is entitled to be paid the bonus". In our view that passage accurately reflects the law, and UBS is right to submit that Rule 2 is concerned with a present entitlement to present payment.

71. We have spent some time on this question of construction because, once it has been resolved, the answer to this part of the case in our judgment becomes clear. Even on the most favourable view of the facts from HMRC's perspective, we do not think it can be said that any of the relevant employees, including those with guaranteed minimum bonuses, became entitled to immediate payment of the sums which UBS decided to award to them on 23 January 2004. Quite apart from the fact that no information about the awards was communicated to the employees at that stage, their only contractual right under their contracts of employment, even after the amount of their bonuses had been privately determined by UBS, was to have it paid to them on or around the February pay day. At best, therefore, it was a right to a future payment, which would not mature into a taxable receipt for income tax and PAYE purposes unless and until it became immediately payable. That never happened, because by prior agreement with the employees who had applied to participate in the scheme, the relevant parts of their bonuses were applied by UBS in the purchase of NVS and the conferral of beneficial interests in those

shares on the employees. The shares were admittedly earnings from the employees' employment with UBS, but they were non-monetary earnings, and by virtue of section 19(4) they were treated as received at the time when the benefit was provided, that is to say on 29 January 2004.

72. In relation to the 416-odd employees who had no guaranteed minimum bonus, the finding by the FTT in paragraph [73] that they "were not entitled to, or to be paid, their bonuses until the February pay day" is in our judgment unassailable. In relation to the handful of employees with a guaranteed minimum bonus, the FTT considered that their entitlement to the minimum amount made all the difference, because they had an enforceable right to be paid that sum. However, it is clear from the sample contract of employment which was considered by the FTT, and extracts from which they quoted, that the cash element of the award, including the guaranteed minimum amount, would be paid after deduction of tax "in or about February following the calendar year specified in the awards". In our view this must be understood as a reference to the February pay day, and there is no ground for supposing that the right to immediate payment of the bonus, or any part of it, would accrue earlier for the employees in this category than it would for those without a guaranteed minimum. Furthermore, there is a logical difficulty in the view which the FTT appears to have adopted that the right to be paid the guaranteed minimum did not accrue until 23 January 2004. Since the guarantee was provided when the contract of employment was entered into, the contractual right to future payment of the guaranteed minimum must have accrued at that date, even if the right was liable to be defeated on the happening of certain conditions (for example if the employee was dismissed for misconduct). At the date when the contract was entered into, the right was on any view a right to payment in the future, and on the construction which we would place on Rule 2 there would be no taxable receipt of it before the future pay day when it was actually paid. We are satisfied, therefore, that the FTT fell into error in holding that the relevant employees received the guaranteed minimum amounts of their bonuses on 23 January 2004.

73. We should add that Mr Lasok advanced a number of further arguments to the general effect that, whatever the original contractual arrangements may have been between UBS and the employees who participated in the ESIP scheme, their contracts must have been varied (whether expressly or by necessary implication) in such a way as to confer a right to immediate payment of the part of their bonuses which was applied by UBS in the purchase of NVS. Only on such a footing, submitted Mr Lasok, could UBS have applied the relevant sums on the employees' behalf. We do not consider it necessary to review these arguments in any detail, however, because we consider that they all suffer from the same fallacy. We are unable to see any necessity, either legal or factual, for the bonuses to have become immediately payable to the employees before UBS could apply them in the purchase of the NVS. It was enough that UBS had decided what amounts it would award to each employee before the scheme was set in motion. There was no need for the employees to have first acquired the right to have the relevant parts of their bonuses paid to

them in money, and in our view there is nothing in the scheme documentation which brought about such a result.

74. For all these reasons, we conclude that there was no receipt of money earnings by any of the employees, including those with guaranteed minimum bonuses, before the scheme was set in motion.

The restricted securities issue: section 423(2)(c)

Introduction

75. UBS argued that no liability to income tax arose in respect of the acquisition of NVS by the employees, because all of the statutory conditions for the application of the exemption in section 425 of ITEPA 2003 were satisfied.

76. First, the NVS were "securities" as defined by section 420, because they were shares in a body corporate. This was not in dispute, and the FTT found that they were "real shares":

> "95. The Tribunal has little trouble in accepting that the NVS were real shares. It was possible for an employee to hold them for over two years, and some did so. If they did so, they received dividends from the sums invested in ESIP Limited and invested by it. Those shares were securities. The more significant question is whether they were restricted securities."

77. Secondly, the NVS were "employment-related securities" as defined by section 421B(1), because the employees acquired their shares by reason of their employments. This too was not in dispute, as recorded in paragraph [87] of the decision:

> "87. It was not in dispute that the employees acquired their interests in the shares in the Scheme by reason of their employments. The Tribunal finds that the day on which the employees acquired their interests in the shares was 29 January 2004."

78. Thirdly, there was "a contract, agreement, arrangement or condition which makes provision … under which … there will be a transfer … of the [NVS] … if certain circumstances arise or do not arise", within the meaning of section 423(1)(a) and (2)(a). This was because article 2(14) of the Articles of Association of ESIP provided that if the FTSE 100 Index exceeded the Trigger Level at any time in the Restricted Period, the NVS had to be sold. Again, this was not in dispute, and the FTT found there was a genuine possibility that the forced sale would occur:

> "62. The Tribunal accepts from the expert evidence, and finds, that the Trigger Event created a genuine uncertainty. It was not likely to occur, but there was a genuine possibility that it could occur. It also finds that the existence of the Trigger Event, and of the effect that this would

> have on ownership of the shares in question, was such as to reduce the market value of the shares when they were acquired by the beneficiaries by a small amount but not so small an amount that it could be ignored as irrelevant to the tests to be applied."

Further, HMRC accepted, and the FTT agreed, that the period of three weeks was not of itself too short to make the restriction a real one (see paragraph [97] of the decision), and the FTT also accepted the submission for UBS that the nature of the restriction did not have to be employee-related (paragraph [98]).

79. Fourthly, the forced sale provision was one under which "as a result of the transfer … the person by whom the [NVS] are held will cease to be beneficially entitled to the [NVS]" within the meaning of section 423(2)(b). This too was uncontroversial, and followed from the express provision in article 2(14) that, upon the happening of the Trigger Event, "the legal and beneficial interest in each NVS in issue shall be immediately and automatically sold to the Purchaser".

80. Fifthly, the forced sale provision must be one under which the holder of the NVS "will not be entitled on the transfer … to receive in respect of the [NVS] an amount of at least their market value (determined as if there were no provision for transfer, reversion or forfeiture) at the time of the transfer …". This requirement is imposed by section 423(2)(c), and the critical issue is whether it was satisfied in the present case. The FTT agreed with HMRC's contention that it was not satisfied, with the consequence that the exemption under section 425 was unavailable and the scheme therefore failed. UBS appeals against that conclusion, and we will return to the issue in detail after completing our review of the requirements of the exemption which are not in dispute.

81. Sixthly, the market value of the NVS at the time of acquisition was "less than it would be but for" the forced sale provision, within the meaning of section 423(1)(b). We have already quoted the FTT's finding to this effect in paragraph [62] of the decision. In so finding, the FTT rejected an argument advanced by HMRC that the reduction in value was de minimis and could be ignored.

82. Finally, the NVS would cease to be restricted securities by virtue of section 423(2) within five years after the acquisition, as required by section 425(1)(b), because the forced sale provision would cease to operate after 19 February 2004.

83. It can therefore be seen that, apart from section 423(2)(c), and subject to what we say in paragraph 108 below, all of the requirements for the section 425 exemption to apply were satisfied, either because they were common ground, or because the FTT made appropriate findings of facts which are no longer challenged. Everything therefore turns on the condition in section 423(2)(c).

The section 423(2)(c) condition

84. As applied to the present case, the requirement laid down by the condition in section 423(2)(c) is that, on the happening of a forced sale, the employee "will not be entitled on the transfer … to receive in respect of the [NVS] an amount of at least their market value (determined as if there were no provision for transfer …) at the time of the transfer …".

85. UBS argues that this condition was clearly satisfied, because article 2(14) provided that in the event of a forced sale the NVS had to be sold for 90% of their market value, determined as if no restrictions applied to the shares. UBS submits that a person cannot be entitled to market value if he is entitled to only 90% of market value. The FTT, however, rejected this simple argument, essentially because in its view the forced sale provisions in the Articles of ESIP had to be viewed in conjunction with the option arrangements which were designed to ensure that the value of the NVS would not be adversely affected if a forced sale took place.

86. The FTT began its discussion of this topic at paragraph [99] of the decision:

> "99. In the view of the tribunal, the Trigger Event and the period chosen are to be seen alongside the call option arrangements to which Mr Lasok QC drew attention. It is clear that from the earliest inception of the thinking that went on about ESIP Ltd, there was a constituent element that involved using a device to neutralise the effect of any Trigger Event. The proposal was that the Trigger Event should be hedged so that if the share prices rose above the level set, then an arrangement should be in place to compensate the company for the loss it would suffer in the enforced sale of its shares. As a result, the company's loss of funds would be made good so that the payout to the shareholders of the NVS would not be affected significantly by the reduction caused by the forced redemption."

87. The FTT then referred to some of the evidence which showed that the planning of this aspect of the scheme went back to August 2003, and remained a central strand thereafter. In particular, it was built into a detailed timeline sent by Rebecca Jackson to Jonathan Ferrara on 22 January 2004 after he had agreed to take on the UBS directorship of ESIP. The FTT then continued:

> "103. The UBS offer was made as planned. It contained the requirement foreseen in the December presentation that ESIP Ltd keep 97% of the capital investment but use 3% for the purchase of options. That was agreed and the options were purchased. The papers also contain documents showing the thinking behind the level of options required. These include drafts of an index call warrant in the name of UBS Investment Bank. The proposal is for a settlement amount of 14.112% on settlement date (20 February 2004) if the FTSE closes above the barrier level on any day between and including 28 January

2004 and 19 February 2004. Someone has annotated this with the handwritten comment:

> "Change forced sale payout from 100% - 99% (demonstrate participants have lost some value) – premiums will reduce,"
>
> 104. The tribunal finds that the events occurred as planned. The agreement between UBS and ESIP Ltd that led to the subscription was duly accepted by both parties, and ESIP Ltd duly agreed to hedge at the level agreed with UBS London Equities. (The evidence is that a complex option was agreed, but the details do not matter). The final terms were a premium of £2.2 million for a payout if the event had materialised that would have left employees with 99.2% of their entitlement. The money given to ESIP Ltd by UBS was therefore split 97/3 as planned.
>
> 105. It is clear to the tribunal from this that there is a close interlinking between the trigger event chosen, the period of the restrictions chosen, and the method of hedging chosen. The aim was at first that there should be a complete offset between the loss to an employee if the Trigger Event occurred with the result communicated to senior management that there would be no reduction in value in the payout to the employee. He or she would receive the same whether or not the Trigger Event occurred. At some point someone thought a deliberate near miss was better than an exact hit in terms of offsetting the loss. As the Trigger Event did not occur, this was not tested.
>
> 106. It is also clear to the tribunal that the reality was that the Scheme as a whole was carefully designed so that employees could not suffer any significant loss if the Trigger Event was realised …
>
> 107. … The specific risk taken as the Trigger Event was, the tribunal finds, deliberately chosen as an objective, limited risk that a counterparty was prepared to offset entirely …"

88. In paragraph [109] the FTT pointed out that a market value criterion is applied twice in the relevant parts of the definition of a restricted security. Section 423(1)(b) lays down the general requirement that the condition imposing the condition must be such that "the market value of the employment-related securities is less than it would be but for that provision", while section 423(2)(c) refers to an entitlement on their transfer to receive "an amount of at least their market value (determined as if there were no provision for transfer …) at the time of the transfer …". Accordingly, said the FTT, the question of market value "must be tested both at onset and on delivery". The FTT then expressed its conclusions as follows:

> "110. There is however a difference in the phraseology of the onset test (section 423(1)(b)) and the delivery test (section 423(2)(c)): the former

is related specifically to the market value of the securities, while the latter is wider. It refers to the entitlement of the employee that arises at the time of the forfeiture. The tribunal is prepared to accept that the amount received by an employee if the Trigger Event occurred was structured so that the market value of the NVS was reduced. But it does not accept that this is the only amount to which the employee would have been entitled under the Scheme at the time of a forfeiture. The employee would also have been entitled to the appropriate share of the sums received on exercising the options. UBS had required ESIP Ltd to invest in the options, and the agreement had taken into account the sums receivable. Further, the employees had all been informed of this, and had themselves entered the Scheme with this information in mind. The amounts receivable by the employees on the event of forfeiture occurring were therefore, as the presentation claimed, bar a small marginal difference, the same as if the forfeiture did not occur. Any difference was not a matter of the market or an unknown amount, but a precisely quantified amount known in advance as a result of a decision taken quite deliberately to structure the option so that it just undershot the amount required to balance the transaction.

111. Further, while the tribunal received limited evidence about the circumstances that might apply had there been a forfeiture, it noted the evidence of Mr Croft that the details of the option were such that there were circumstances in which the amount received on forfeiture could exceed the main level of return under the option, so raising the possibility that the effect of the forfeiture happening could be a gain, not a loss. Mr Croft stated that there was a very low probability of this occurring … It is a marginal additional aspect of the general reality of the situation that no significant loss would occur if the Trigger Level was crossed. That situation is a probably marginal loss of under 1% in the improbable event that the Trigger Level was crossed with a remote possibility of a gain. That is to be compared with the picture presented by [UBS] of a 10% loss.

112. Taking all the evidence into account, the tribunal finds as fact that, on a straightforward interpretation of the language of the statute, the test in section 423(2)(c) … is not met.

113. It was not argued for [UBS] that any other aspect of the tests in section 423 was met on the facts. Accordingly, the tribunal finds that the securities were not "restricted securities" within the meaning of Chapter 2.

114. It follows that the appeal must fail".

89. On behalf of UBS, Mr Prosser subjected the FTT's reasoning on this issue to some searching criticisms. He began by pointing out that there is a thread which runs through the FTT's treatment of the subject, namely that the option

arrangements were designed to offset a “loss” to the employee: see the repeated references to “loss” in paragraphs [99], [105] (twice), [106], [111] (three times), [136] and [139]. Mr Prosser argued that this concentration on “loss” seems to have misled the FTT into thinking that section 423(1)(c) required the employees to suffer a loss if a forced sale occurred, and that this requirement was then negated by arrangements which had the consequence that no significant loss would in fact be incurred, and the requirement would therefore not be satisfied. Such an analysis, said Mr Prosser, lies at the heart of the FTT’s reasoning in paragraph [111], and must be what lies behind their finding in paragraph [112] that the test in section 423(2)(c) was not satisfied.

90. Mr Prosser next submitted that, by introducing into the subsection a requirement for a “loss” of some kind to be suffered, the FTT had placed an unwarranted gloss on the clear and highly prescriptive statutory language. The statutory test does not mention, or require, a loss of any kind, but merely requires the amount receivable on a forced sale to be less than the market value of the shares at the time of the forced sale, determined as if there were no forced sale provision. Had the FTT asked itself that question, it could only have concluded that the employees would receive less than the market value of their shares, because they would receive only 90% of the market value. The effect of the option arrangements would admittedly be to make the market value of the shares higher than it would have been in the absence of the arrangements, because the assets of the company would be increased by the option proceeds (from £100 to £110, in the simplified example given in paragraph 49 above); but it would still be only 90% of the increased market value that the employees received (£99 instead of £110).

91. Further, by failing to focus on the actual wording of section 423(2)(c), the FTT had asked itself the wrong question. What the FTT did was to compare the amount which an employee would receive on a forced sale (that is to say, if the Trigger Level were reached and the option were triggered), with what he would receive, on a later redemption, if the Trigger Level were *not* reached and the option were *not* triggered. In other words, the FTT compared the £99 in the example with the £97 which the employee would receive on redemption, and rightly concluded that the employee would not receive less in the first scenario, and therefore did not suffer a “loss”. But the relevant market value for the purposes of section 423(2)(c) is the market value of the shares if there were no forced sale provision, *not* the market value if the forced sale provision did not operate because the Trigger Level was not reached.

92. Mr Prosser argued that UBS’s interpretation of section 423(2)(c) must be right, both as a matter of linguistic analysis and on a more purposive approach. As a matter of language, the words “determined as if there were no provision for transfer” clearly indicate that it is simply the provision itself which is assumed not to exist. Moreover, similar assumptions are made elsewhere in Chapter 2. Section 423(1)(b) requires the market value to be “less than it would be but for the provision”, so that the only differences between the market values in subsections (1)(b) and (2)(c) is that the former must be

determined as at the time of acquisition, whereas the latter must be determined at the time of the forced sale and, if indeed it gives rise to a difference, the first is to be determined as if there were no provision within (1)(a) , and the second as if there were "no provision for transfer, reversion or forfeiture". Similarly, section 428 (amount of charge) requires the market value to be determined "but for any restrictions", and the election provisions in section 431 require the market value of restricted securities to be calculated "as if they were not [restricted]". As Lord Walker explained in Gray's Timber at [33], these (and other similar) provisions in Part 7 proceed on the footing that the restriction "affects the market value of the securities in question".

93. As a matter of purposive interpretation, submits Mr Prosser, the reason for the legislative assumption that there is no provision for forced sale is because section 423(2)(c) is aimed at circumstances where, on the forced sale, the employee will receive less than the "true" market value of the employment-related securities. Since the forced sale provision, in itself, has a depressing effect on value (because, if it did not, the condition in section 423(1)(b) would not be satisfied), the provision must be ignored in order to arrive at the "true" market value. But it would make no sense to make any further counterfactual assumptions, in the absence of any express direction to do so, because it would then become virtually impossible to determine market value.

94. On behalf of HMRC, Mr Lasok sought to uphold the reasoning and conclusion of the FTT. His starting point was that when deciding what a contract, agreement or arrangement "makes provision" for, one is entitled to look at the whole of it, and the question posed by section 423(2)(c) is therefore whether the contract, agreement or arrangement in question, *considered as a whole*, provides that the person holding the securities *will not* be entitled to receive an amount of at least what the market value would have been in the absence of provision for transfer, reversion or forfeiture.

95. Mr Lasok submits that the test in section 423(2)(c) involves consideration of two amounts: (i) the amount to which the person holding the shares is entitled upon transfer, reversion or forfeiture ("the First Amount"); and (ii) the market value of the employment-related securities at that time, if there had been no provision for transfer, reversion or forfeiture ("the Second Amount"). The First Amount is specified as that which the holder of the securities is entitled "on the transfer, reversion or forfeiture to receive in respect of the employment-related securities". The Second Amount is the market value of the securities as at the time of the transfer, reversion or forfeiture. By virtue of section 432(2) of ITEPA, "market value" has the same meaning as in section 421(1), which in turn refers to the meaning accorded to that phrase in Part 8 of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992"). For present purposes, however, nothing turns on the definition in Part 8 of TCGA 1992, and the difference between the parties concerns the meaning of the words "determined as if there were no provision for transfer, reversion or forfeiture". HMRC submit that the meaning attributed to those words by UBS is unduly narrow, and that the statutory test requires the valuation to be carried out by

reference to the situation that would in fact have pertained in the absence of such provision. Finally, the words “will not” in section 423(2)(c) show that it must definitely be the case that the First Amount will be less than the Second Amount.

96. Turning to the application of section 423(2)(c), thus construed, to the facts of the case, Mr Lasok begins by pointing to the definition of “Market Value” in article 1.1 of the Articles of Association of ESIP, namely:

> “the price estimated in good faith by the Directors to be obtainable for the share or shares concerned on a sale in the open market between a willing seller and a willing buyer on the relevant date, if no restrictions (including for the avoidance of doubt under Articles 2(14) or 2(15)) applied to those shares.”

97. The “Forfeiture Price” is defined as meaning 90% of the Market Value of a NVS on the Forced Sale Date. By these means, says Mr Lasok, UBS sought to align the definition of “Market Value” in the Articles with the Second Amount, and to ensure that the First Amount would, by definition, be below the Second Amount.

98. However, it was never UBS’s intention that there should, in reality, be any material difference between the two amounts. As to the First Amount, the scheme was structured in such a way that, if the Trigger Event occurred, the employee would receive in cash an amount approximately equivalent to the original face value of the NVS, i.e. the amount of the original bonus expressed in cash form. This was made clear in the November 2003 brochure, which explained (see paragraph 42 above) that “the sale proceeds if the Forced Sale Provision applies are expected to be approximately equal to the original Face Value of the preference shares”. This result would be brought about by the hedging arrangements, which as the FTT found were designed to yield approximately 99% of the employees’ bonus entitlements, with the remote possibility of a small gain.

99. As to the Second Amount, compliance with section 423(2)(c) was intended by UBS to be a kind of self-fulfilling prophecy, but this depended on reading the words “if no restrictions … applied to those shares”, in the definition of “Market Value” in the Articles, as meaning the same as the words “as if there were no provision for transfer, reversion or forfeiture” in section 423(2)(c). In order to apply the statutory test, it is first necessary to identify precisely what the statutory hypothesis requires. Was it, as the designers of the scheme evidently assumed, that the hypothetical situation was one in which the shares were not subject to the Forced Sale Provision, but in all other respects the situation was the same as it actually was? Or should the hypothesis extend to include the call options, which had no commercial function whatsoever other than to safeguard the position of the employees from the risk resulting from the possible forced sale of the shares? The only possible conclusion on the evidence was that, if there had been no Forced Sale Provision, there would

have been no call options. Accordingly, on the true construction of section 423(2)(c), the statutory hypothesis requires one to disregard the call options as well as the Forced Sale Provision. In that event, there would have been no application of 3% of the subscription monies in acquiring the call options, and ESIP would have held on deposit 100% of the subscription price paid by UBS. That money was earmarked for the purchase of UBS shares by the directors of ESIP in the last five days of February 2004, with the first opportunity to redeem the NVS for cash following some three weeks later on 22 March 2004. The market value of the NVS at the Forced Sale Date, whenever during the Restricted Period that date occurred, would necessarily have been somewhat less than the face value of the shares, because a discount would have to be made to represent the uncertainties concerning the UBS share price, both at the date (after the Forced Sale Date) of their purchase by ESIP and at the first redemption date. Thus the Second Amount would inevitably have been somewhat less than the cash amount of the bonus entitlement.

100. In those circumstances, submits Mr Lasok, the FTT could not possibly have concluded that the First Amount "will not be … an amount of at least" the Second Amount. At most, the Second Amount might possibly have been negligibly more than the First Amount, but that should be ignored as being *de minimis*.

101. In assessing these submissions, we begin by saying that we substantially agree with Mr Prosser's criticisms of the FTT's focus on the idea of a "loss" suffered by the employee, rather than on the comparison which is required by section 423(2)(c). With the greatest respect to the FTT, it seems to us that its decision on this issue betrays a confusion between the commercial purpose of the hedging arrangements, which was to ensure (broadly speaking) that the amount received by the employees on a forced sale of their NVS would be equivalent to the cash value of their bonuses, and the question posed by section 423(2)(c), which is whether upon a forced sale the employees would not be entitled to receive in respect of their NVS an amount of at least the market value of the NVS at the time of the transfer, such market value to be determined "as if there were no provision for transfer".

102. If the answer to the question thus posed is that, on a forced sale, the employees will *not* recover at least the market value of their NVS (disregarding the transfer provision), it then follows that the NVS were restricted securities within the meaning of section 423, and that the effect of section 425(1) and (2) was to exclude an Abbott v Philbin charge to income tax in respect of their acquisition.

103. We next ask ourselves why section 423(2)(c) requires the provision for transfer to be disregarded in ascertaining the market value of the NVS. The answer, we think, again in general agreement with Mr Prosser's submissions, is to deal with a familiar problem thrown up by the CGT definition of market value (which is incorporated into Part 7, as we have noted, by sections 432(2) and 421(1) of ITEPA). The general rule in TCGA section 272(1) is that

market value "in relation to any assets means the price which those assets might reasonably be expected to fetch on a sale in the open market". The rest of the definition is conveniently set out by Lord Walker in Gray's Timber at [22], where he pointed out that it can be traced back to the days of estate duty when it was the subject of several leading cases, including Attorney General v Jameson [1905] 2 IR 218, Salvesen's Trustees v IRC (1930) SLT 387, IRC v Crossman [1937] AC 26 and In Re Lynall, deceased [1972] AC 680.

104. Lord Walker then continued:

"23. All these cases … were concerned with the valuation of shares in private companies where the articles contained restrictions on transfer and rights of pre-emption. There is not, as it seems to me, much difference in the general conclusions which the parties seek to draw from these authorities. It is not therefore necessary to multiply citations. It is sufficient to repeat two passages which were quoted with approval in *In re Lynall* (by Lord Reid, at p 693, and Lord Pearson, at p 704 respectively). The first is from the judgment of Holmes LJ in the *Jameson* case [1905] 2 IR 218, 239:

"The Attorney General and the defendants agree in saying that in this case there cannot be an actual sale in open market. Therefore, argue the former, we must assume that there is no restriction of any kind on the disposition of the shares and estimate that [sic] would be given therefor by a purchaser, who upon registration would have complete control over them. My objection to this mode of ascertaining the value is that the property bought in the imaginary sale would be a different property from that which Henry Jameson held at the time of his death. The defendants, on the other hand, contend that the only sale possible is a sale at which the highest price would be £100 per share, and that this ought to be the estimated value. My objection is that this estimate is not based on a sale in open market as required by the Act. Being unable to accept either solution, I go back to my own, which is in strict accordance with the language of the section. I assume that there is such a sale of the shares as is contemplated by article 11, the effect of which would be to place the purchaser in the same position as that occupied by Henry Jameson. An expert would have no difficulty in estimating their value on this basis. It would be less than the Crown claims, and more than the defendants offer; but I believe that it would be arrived at in accordance not only with the language of the Act, but with the methods usually employed in valuing property."

24. The second is from the judgment of Lord Fleming in the *Salvesen* case (1930) SLT 387, 391:

"The Act of Parliament requires, however, that the assumed sale, which is to guide the commissioners in estimating the value, is to take place in the open market. Under these circumstances I think that there

> is no escape from the conclusion that any restrictions which prevent the shares being sold in an open market must be disregarded so far as the assumed sale under section 7(5) of the Act of 1894 is concerned. But, on the other hand, the terms of that subsection do not require or authorise the commissioners to disregard such restrictions in considering the nature and value of the subject which the hypothetical buyer acquires at the assumed sale. Though he is deemed to buy in an open and unrestricted market, he buys a share which, after it is transferred to him, is subject to all the conditions in the articles of association, including the restrictions on the right of transfer, and this circumstance may affect the price which he would be willing to offer.""

105. In the light of these well-established principles, it seems to us that Parliament's concern in section 423(2)(c) must have been to negate the depressing effect on market value which would otherwise be caused by the hypothetical acquisition of the relevant securities by the purchaser subject to the provision for transfer, reversion or forfeiture, and to ensure that if the employee were entitled to receive only the depressed market value of the securities, they would still be restricted securities for the purposes of Chapter 2. If, on the other hand, the employee would demonstrably be entitled to receive what one might call the "true" or "full" underlying market value of the securities, on the assumption that the securities were not subject to any provision for transfer, reversion or forfeiture, there would then be no reason to treat them as restricted securities, and equally no reason to disapply an Abbott v Philbin charge to income tax on their acquisition (because the full underlying market value of the securities would be charged to tax).

106. If we have correctly identified the statutory purpose, we consider that there is then little room for doubt about the answer to the question in the present case. The "provision for transfer" which has to be disregarded is the provision for transfer in the articles of ESIP, which would otherwise have had a potentially depressing effect on the market value of the NVS on a forced sale. It does not extend to the hedging arrangements, which were purely collateral and served the different purpose of ensuring that the employees would not end up significantly out of pocket if a forced sale occurred. We are unable to see any relevant distinction between the wording of section 423(2)(c) and the wording of the transfer provisions in the articles of ESIP in relation to the computation of market value, and since the employees were to receive only 90% of the market value of their NVS in the event of a forced sale, the conclusion that they would *not* be entitled to receive at least the market value of their shares is in our judgment inescapable.

107. We have primarily based our conclusion on a purposive analysis of section 423, but we also consider that our conclusion fits much better with the statutory language than the analysis advanced by HMRC. Although the hedging arrangements owed their existence to the Forced Sale Provisions in the articles, and although (as Mr Lasok memorably observed at one point) they

were the one truly commercial element in the whole structure, they were nevertheless not *provisions for transfer* of the NVS. They were provisions intended to deal with the consequences of the transfer, or (more accurately) with the consequences of the happening of the Trigger Event, by swelling the assets of the company to a predetermined level. They were not, in themselves, provisions which actually brought about the transfer. The sole trigger of the obligation to transfer the shares was the specified increase in the FTSE 100 Index.

108. We would add one observation. Although we are satisfied that the only "provision" which section 423(2)(c) requires to be disregarded is the provision for transfer in the articles of ESIP, it is not obvious to us that the scope of the "provision" which has to be disregarded at the date of acquisition of the NVS under section 423(1)(b) was necessarily subject to the same limitation. In the latter context, we think that "provision" must potentially have a wider scope, if only because it covers any provision to which any of subsections (2) to (4) apply. It may therefore be arguable that, for the purposes of section 423(1)(b), it would be right to take account of the hedging arrangements in determining whether the market value of the NVS was "less than it would be but for that provision". However, no such argument appears to have been addressed to the FTT, and (no doubt for good reason) HMRC have not sought to argue before us that the condition in section 423(1)(b) was not satisfied, or that the FTT's finding that it was (in paragraph [62] of the decision) was wrong.

109. For these reasons, we respectfully think that the FTT came to the wrong conclusion on this issue, and that the exemption in section 425 therefore applied. Nor, in our view, is there anything obviously "wrong", or surprising, about this conclusion, because if the NVS were indeed restricted securities, the effect of exemption under section 425 is normally to set up a charge to tax under section 426 on the occurrence of a chargeable event. It is common ground that the ending of the Restricted Period was a chargeable event, with the result that everything turns on the availability (or not) of the further exemption contained in section 429. Accordingly, that is the issue to which we now turn.

<u>The control issue: section 429(4)(d)</u>

<u>Introduction</u>

110. The ending of the Restricted Period was a chargeable event by virtue of section 427(2) and (3)(a), because the NVS then ceased to be restricted securities in circumstances in which "an associated person", namely the employee, was beneficially entitled to the NVS after the event. The definition of "associated persons" in section 421C(1) includes, in paragraph (b), "the employee". The NVS ceased to be restricted securities on 19 February 2004 (the end of the Restricted Period) because they were no longer subject to the forced sale provision.

111. Accordingly, a charge to tax then arose under section 426, on the full unrestricted market value of the NVS, unless the exemption in section 429 applied. We have set out the relevant parts of section 429 in paragraph 29 above. The FTT held that the exemption would have applied, if (contrary to its decision on the restricted securities issue, and as we have held) the NVS were restricted securities. That conclusion is challenged by HMRC as being wrong in law.

112. We remind ourselves at this point that an appeal from the decision of the FTT lies only on questions of law. It is only open to us to interfere with findings of fact made by the FTT if they betray an error of law in the sense explained by the House of Lords in Edwards v Bairstow [1956] AC 14: see the well-known passages in the speeches of Viscount Simonds at 29 to 32 and Lord Radcliffe at 33 to 36 and 38 to 39.

113. Section 429 applies if four conditions are satisfied. First, the employment-related securities (here the NVS) must be “shares (or an interest in shares) in a company of a class”: section 429(1)(a). Secondly, the forced sale provision must apply to all the shares of the class: section 429(1)(b). Thirdly, all the shares of the class other than the employment-related securities must be “affected by an event similar to that which is a chargeable event”, which in the present context means the forced sale provision ceasing to apply to them: section 429(1)(c) and (2)(a). It has throughout been common ground that these three conditions are satisfied. As to the third condition, a possible construction might be that it positively requires the shares to be a mixed class comprising both employment-related and non-employment related securities. Mr Lasok submitted, however, that the class does not have to be mixed, and the condition applies only if the class is in fact mixed. He may well be right, but we do not need to decide the point because we agree with Mr Prosser that the question of exemption logically has to be considered in relation to each individual employee and his own holding of employment-related securities. Thus the employment-related securities referred to in section 429(1) are those held by the relevant employee, and the third condition will be satisfied even if all the other shares in the class are also employment-related securities in different ownership.

114. The fourth condition, by virtue of section 429(1)(d) and (4), is that immediately before the termination of the forced sale provision, the majority of the shares of the class were not held by or for the benefit of certain specified persons, including (relevantly) “employees of any associated company” of ESIP. This is the crucial condition, and the issue is whether on 19 February 2004 UBS was an associated company of ESIP. If it was an associated company of UBS on that date, the NVS were then held for the benefit of employees of an associated company of ESIP, so the condition was not satisfied, and the exemption was not available. Conversely, if UBS was *not* an associated company of ESIP, the condition was satisfied, and the exemption was available.

115. Pursuant to section 432(6) and 421H, "associated company" has the same meaning in Chapter 2 as, by virtue of section 416 of ICTA 1988, it has for the purposes of Part 11 of that Act.

116. Section 416 of ICTA 1988 provides as follows:

> "(1) For the purposes of this Part … a company is to be treated as another's "associated company" at a given time if, at that time or at any other time within one year previously, one of the two has control of the other, or both are under the control of the same person or persons.
>
> (2) For the purposes of this Part, a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs, and in particular, but without prejudice to the generality of the preceding words, if he possesses or is entitled to acquire –
>
> > (a) the greater part of the share capital or issued share capital of the company or of the voting power in the company; or
> >
> > (b) such part of the issued share capital of the company as would, if the whole of the income of the company were in fact distributed among the participators (without regard to any rights which he or any other person has as a loan creditor), entitle him to receive the greater part of the amount so distributed; or
> >
> > (c) such rights as would, in the event of the winding-up of the company or in any other circumstances, entitle him to receive the greater part of the assets of the company which would then be available for distribution among the participators.
>
> (3) Where two or more persons together satisfy any of the conditions of subsection (2) above, they shall be taken to have control of the company.
>
> (4) For the purposes of subsection (2) above a person shall be treated as entitled to acquire anything which he is entitled to acquire at a future date, or will at a future date be entitled to acquire.
>
> (5) For the purposes of subsections (2) and (3) above, there shall be attributed to any person any rights or powers of a nominee for him, that is to say, any rights or powers which another person possesses on his behalf or may be required to exercise on his direction or behalf.
>
> (6) For the purposes of subsections (2) and (3) above, there may also be attributed to any person all the rights and powers of any company of which he has, or he and associates of his have, control or any two or

more such companies, or of any associate of his or of any two or more associates of his, including those attributed to a company or associate under subsection (5) above, but not those attributed to an associate under this subsection; and such attributions shall be made under this subsection as will result in the company being treated as under the control of five or fewer participators if it can be so treated."

117. The leading authority on the interpretation of section 416 is the decision of the House of Lords in R v IRC, ex parte Newfields Developments Ltd [2001] UKHL 27, [2001] 1 WLR 1111. The leading speech was delivered by Lord Hoffmann. After setting out the terms of the section, he said this:

> "10. It will be seen that although this definition starts in subsection (2) with a concept of control which reflects its meaning in ordinary speech ("a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs"), that fairly simple notion is enormously widened by subsequent subsections. Subsection (4) deems the person in question to already have interests which have not yet vested and subsection (5) attributes to him the rights or powers of his nominees. Subsection (6) goes much further in providing that for the purposes of deciding whether a person falls within the definition in (2) (or the definition of joint control in (3)) any person may have attributed to him the rights or powers of any associate or of any company [of] which he or his associates or both have control. The full breadth of this extension can be seen from the definition of "associate" in section 417(3) …
>
> 11. … The effect of these cumulative definitions is that for the purpose of deciding whether a person "shall be taken to have control of a company" under section 416(2), it may be necessary to attribute to him the rights and powers of persons over whom he may in real life have little or no power of control. Plainly the intention of the legislature was to spread the net very wide."

118. Lord Hoffmann also observed at [19]:

> "If real control were to be the test, the opening words of section 416(2) would be enough. The purpose of the extended definition appears to be to make it unnecessary for the revenue to have to make detailed factual inquiries."

119. There are some other authorities on the construction of section 416 to which we need to refer. In Steele v European Vinyls Corp (Holdings) BV [1995] STC 31, 69 TC 88, it was held at first instance by Lightman J, at 51e, that in section 416(2) "[c]ontrol over the company's affairs refers to control at

general meetings, and not board level". The judge then gave two reasons for so holding:

> "That this is the criterion intended by the section is confirmed by two considerations. First, section 416 is part of the anti-avoidance legislation relating to "close companies" which is directed at the ownership of the company in question and the underlying entitlement of shareholders to the income of the company. Secondly, the specific tests in 416(2) are concerned solely with the rights of the participators, and in particular in section 416(2)(a) the possession (or entitlement to acquire) the share capital or voting power. It is not conceivable that the legislation had in mind control by "shadow directors", i.e. persons according to whose directions or instructions the directors are accustomed to act. There is no requirement that the person possessing control should interfere, or have any right to interfere, in the management of the business of the company."

120. In the Court of Appeal, the decision of Lightman J on this point was upheld: see Steele v EVC International NV [1996] STC 785 (the company concerned had changed its name in the meantime to EVC International NV). The leading judgment was delivered by Morritt LJ. At 792 to 795 he considered, and rejected, a submission on behalf of EVC that "control over the company's affairs" in section 416(2) must refer to all the company's affairs, including those ordinarily subject to the control and management of the directors, and not merely those which are conducted at general meetings of the company. Having reviewed the earlier authorities relied upon by counsel for EVC, Morritt LJ concluded at 794j:

> "In my view control of the affairs of the company in section 416 means control at the level of general meetings of the company in the sense explained in the cases to which I have referred. Those cases recognise that control at that level carries with it the power to make the ultimate decisions as to the business of the company and in that sense to control its affairs."

121. That statement about the meaning of control in section 416 is in our judgment binding upon us. So much was common ground before the FTT, but before us Mr Lasok sought to argue that the criterion of control exclusively at shareholder level had been implicitly overruled by the Newfields case in relation to the general test in the opening words of section 416(2). We are unable to accept this submission. There is no discussion of Steele, or indeed of any earlier case law, in Newfields, and the level of control contemplated by the section was simply not in issue. Thus when Lord Hoffmann described the test in the first part of subsection (2) as a "fairly simple notion", which reflects the meaning of "control" in ordinary speech, we consider that we are bound by Steele to look only at control of the company at shareholder level, in the sense (as Morritt LJ put it) of "the power to make the ultimate decisions as to the business of the company and in that sense to control its affairs".

122. In their skeleton argument, counsel for HMRC also referred to the relatively recent decision of the Court of Appeal in Kellogg Brown & Root Holdings (UK) Ltd v Revenue and Customs Commissioners [2010] EWCA Civ 118, [2010] STC 925, where Lord Neuberger MR (with whose judgment Longmore and Smith LJJ agreed) referred to the observations of Lord Hoffmann and Lord Scott of Foscote in Newfields and said at [34]:

> "It seems to me that those observations confirm the approach taken by the Chancellor, and which I would adopt, namely to give the opening part of section 416(2) its ordinary meaning, and certainly not to give it an artificially narrow meaning because of the following subsections."

123. Read in isolation, this passage might appear to provide some support for HMRC's argument; but when read in context, we do not think that it does more than reinforce the clear contrast between the general opening words of section 416(2) and the greatly extended scope of the following subsections. Lord Neuberger MR noted at [33] that the concept of "control" in section 416 had been held in Steele to mean "control at the level of general meetings of the company", and he nowhere suggested either that the test was wrong, or that it had been impliedly overruled by Newfields.

124. To conclude, therefore, we are satisfied that we must proceed on the basis that "control" in section 416 means control at shareholder level.

The Decision of the FTT

125. The FTT dealt with this part of the case with comparative brevity, in paragraphs [119] to [122] of its decision:

> "119. Mr Lasok QC submitted that UBS was an associated person with ESIP Ltd at that time. "Associated person" has the same meaning for these purposes as in section 416 of ICTA (see section 421H of ITEPA). That definition is set out above. His argument was that in reality UBS controlled ESIP Ltd. ESIP Ltd did what it was told by UBS, and it did not exercise any initiative of its own.
>
> 120. Mr Prosser QC strongly resisted that argument, and relied on the evidence of his witnesses, and in particular Mr Ferrera, as the basis for his submission that ESIP Ltd was an independent company. The evidence showed that two of its three directors were not appointed by UBS or associated with it, but were appointed by the independent company, Mourant, who by its nominees held the other voting shares in ESIP Ltd. They had held real meetings and made real decisions.
>
> 121. While the language of the timeline details cited above from the internal UBS memorandum sent to Mr Ferrera after he had agreed to become a director, and the extent to which events followed the timeline, certainly justify Mr Lasok QC in raising the argument and seeking to test the evidence thoroughly, the tribunal agrees with Mr

Prosser QC. It follows from its general finding that its starting point in the analysis is that events occurred as the operative documents (and not merely the timelines) suggested.

122. The tribunal does not consider that it needs to examine the corporate structure of ESIP Ltd beyond the general finding that the NVS were held by UBS and the UBS employee benefit trust as detailed in the chronology in the annex to this decision. When the shares were sold, the sale was to UBS. That was not in dispute. The sole area of dispute was whether UBS was an associated person with ESIP Ltd within the section 416 meaning. The tribunal regards this as relatively straightforward. On the basis of its main findings of fact, it sees nothing unusual or untoward about the relationship between the two companies, and it saw no evidence to suggest there was control of the kind envisaged by section 416. It does not consider therefore that it need enter into a detailed analysis of the section. It finds on the facts that the evidence does not show that UBS and ESIP Ltd are associated persons."

126. We would add two points. First, our reading of paragraph [120] is that the whole of it records submissions made by Mr Prosser. Thus, when the FTT said in the following paragraph that it agreed with Mr Prosser, we think that it meant to record its agreement with all of his submissions summarised in paragraph 120. Secondly, although the FTT did not refer to any authority, it is clear from its decision in DB that it had been referred to the guidance in Newfields and Steele: see paragraphs [84] and [85], the latter of which records Mr Lasok's acceptance "that the control in this sense was control by general meeting, not the control of the board of directors".

Discussion

127. Against this background, Mr Lasok realistically accepted that any challenge to the FTT's conclusion that there was no control of the kind envisaged by section 416 would have to be made on Edwards v Bairstow grounds. This was always going to be difficult to achieve, given that the FTT was not alleged to have expressly misdirected itself on the relevant law, and given that it had reviewed the extensive documentation in the case and heard oral evidence from the witnesses of fact, including Mr Ferrera, in the course of a five day hearing. The task became even harder when it transpired that Mr Lasok was inviting us to overturn the FTT's decision without taking us to any transcripts of the oral evidence, or even to the underlying witness statements. How, in those circumstances, could we sensibly be asked to hold that the FTT must have erred in law in concluding that UBS did not at any material time within the one year period referred to in section 416(1) satisfy the test in subsection (2) of actual control, at shareholder level, over the affairs of ESIP?

128. Counsel for HMRC sought to persuade us to do so by deploying in their skeleton argument a lengthy, but selective, array of documents designed to establish that:

(a) the actions of ESIP were predetermined by UBS, and were carried out "on auto-pilot";

(b) the decisions ostensibly taken by ESIP were in fact taken by UBS;

(c) the directors of ESIP exercised no independence, but simply complied with the wishes of UBS; and

(d) Mourant (the holder of the majority of the voting ordinary shares in ESIP) viewed UBS as being in charge of ESIP.

129. So, for example, under heading (a) reference was made to documents at the planning stage between August and October 2003 which showed that UBS expected the special purpose vehicle ("SPV") company to "effectively run on auto-pilot", or to operate as a "clockwork" SPV whose activities would be predetermined by its articles. Under heading (b), reference was made to written records of meetings which took place between representatives of UBS and Mourant on 11 December 2003 and 9 January 2004 at which the future activities of ESIP were agreed and mapped out, before it had even been incorporated. Under heading (c), reference was made to concerns expressed by Mr Ferrera's line manager about his proposed appointment as a director of ESIP, and whether he would be able to engage properly in his role without assuming a significant workload. Rebecca Jackson sought to allay these concerns by saying that most of ESIP's activities would have been "set out in the Articles and associated legal documentation", and "We do not anticipate that the workload would be of great significance …". Again, reference was made to evidence suggesting that the decisions taken at the key board meetings of ESIP on 27 and 28 January 2004 were preordained, were not the subject of any independent consideration by the directors, and were mere formalities. Under heading (d), reference was made to an email sent on 22 January 2004 by Mourant to UBS, enquiring whether UBS would like Mourant to submit its invoice for legal work "to ESIP Limited or to UBS". On 10 February 2004, Mourant sent UBS an invoice for work done to date which amounted to £100,762.86, and in a letter of the same date Mourant explained the fees that it would be charging ESIP and sent UBS a copy of ESIP's invoice. Such behaviour would not have been appropriate, submitted counsel, if UBS and ESIP were not associated companies.

130. Quite apart from the selective nature of this material, there are at least two other reasons why it is in our view inadequate for its intended purpose. First, a great deal of it relates to the activities of ESIP at board level, whereas what needs to be established is control at shareholder level. Secondly, much of it is aimed at establishing that the activities of ESIP were for all practical purposes preordained, in the sense that there was no reasonable likelihood that

ESIP would not play its planned role in the scheme. But in the present context that is not the issue or could only be part of the test, and an affirmative answer to it is an answer to the wrong question, or at the very least is not in itself conclusive.

131. It needs to be remembered that Mourant was a Jersey-based company, part of the well-known Mourant group, which the FTT found in paragraph 66 of its decision to be "unrelated to UBS". Mourant held the majority of the voting shares in ESIP, as trustee of the charitable Sidemore Trust. On the face of it, shareholder control of ESIP clearly resided with Mourant, not with the minority voting shareholder UBS. Equally, it would on the face of it have been a serious breach of Mourant's fiduciary duties as a charity trustee to cede that control to its unrelated minority co-shareholder. Unfortunately, such things can and do happen in the sometimes murky world of offshore tax avoidance, and the FTT was in our view quite right to recognise that HMRC were justified in raising the question and thoroughly testing the evidence. But the result of that exercise was the FTT's findings of fact which we have recited, including (via its acceptance of Mr Prosser's submissions) that the board of ESIP "had held real meetings and made real decisions"; that there was nothing unusual or untoward about the relationship between UBS and ESIP; and that it had seen "no evidence to suggest there was control of the kind envisaged by section 416". We find it impossible to conclude, on the material placed before us, that these conclusions were ones such that, to quote Lord Radcliffe in Edwards v Bairstow, *loc.cit.*, at 36 "no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal". Whether we would ourselves have reached the same conclusions is irrelevant. The FTT was the sole tribunal of fact, and in the absence of any demonstrable error of law we are not entitled to interfere with its findings.

132. We should also record that, in addition to relying on the first limb of section 416(2), HMRC had earlier sought to rely on subsection (3). The argument was that UBS and Mourant together exercised control over ESIP, in the sense that Mourant agreed to exercise its majority voting control of ESIP in accordance with the wishes of UBS. For this purpose, HMRC relied on the observations of Chadwick LJ in Foulser v MacDougall [2007] EWCA Civ 8, [2007] STC 973, where at [42] he said of the similar test in relation to connected persons in section 839(7) of ICTA 1988 and section 286(7) of TCGA 1992, whereby "[a]ny two or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another":

> "I would hold, also, that there is no reason why the concept of two or more persons "acting together to … exercise control of a company" should, necessarily, be confined to cases where each of the persons acting together has less than a controlling shareholding, so that (absent some combination between them) none would be able to exercise control individually. It seems to me that the concept is sufficiently

> wide to include cases where one person (who has shareholder or voting control) agrees to exercise that control in accordance with the wishes of another."

133. Longmore LJ and Lindsay J agreed with the judgment of Chadwick LJ, without adding anything further on this point. It seems to us that this is the most attractive way of putting the argument for HMRC, but again it falls down on the findings of fact actually made by the FTT. Any such agreement would have amounted to a ceding of shareholder control by Mourant to UBS; but if the FTT had considered that to be the true position, it could not have made the findings which it did.

The "sham" argument

134. Apart from their general attack on the FTT's conclusions on the question of control, HMRC have a separate and largely self-contained argument based on the contention that article 2(15) of the Articles of ESIP is an artificial device which was never intended to have legal effect, and that it should therefore be disregarded. If that contention is correct, it is common ground that UBS would then have had control of ESIP within the meaning of section 416(2) for the short period of about one day between its subscription for the NVS on 28 January 2004 and the award of the shares to the employees (and the UBS Employee Master Trust) on 29 January. By virtue of the one year retrospection provided for in section 416(1), such control would suffice to satisfy the statutory test, and the exemption in section 429 of ITEPA would accordingly be unavailable.

135. In our view this is an important argument, which deserves careful attention – and perhaps all the more so because Mr Prosser sought to deal with it very briefly in both his oral and written submissions.

136. We have already given a brief summary of the terms of article 2(15) in paragraph 46 above. It provides as follows:

> "(15) Notwithstanding the preceding provisions of these Articles and anything else expressed or implied in these Articles, at any time at which the Holder or beneficial owner of any Non-Voting Share is a Group Company [*defined as meaning any of UBS AG and its Subsidiaries*], that Non-Voting Share shall, except to the extent that such Group Company is the Purchaser and has acquired the Non-Voting Share pursuant to Article 2(14), confer the following rights and for the avoidance of doubt the provisions set out in Articles 2(7) to 2(14) (other than Article 2(13)) shall not apply to that Non-Voting Share:"

The sub-paragraphs (a) to (e) that follow remove all rights to substantial dividends and distributions, together with the right to receive notices of or to vote at any meetings save those affecting the NVS; entitle the holders of the

NVS to recover only the nominal value of the shares on a winding-up; and prohibit any transfer or redemption of the NVS.

137. The evident purpose of this provision was to negate the existence of control in the section 416 sense during the brief interval to which we have referred. But for article 2(15), the rights to dividends and distributions carried by the NVS under article 2(7) would undoubtedly have conferred control of ESIP on UBS while UBS was the beneficial owner of the shares: see section 416(2)(b) and (c). Thus it was essential to the working of the scheme that article 2(7) should, in effect, be disapplied during the period of ownership of the NVS by UBS, however short that period might be. So much was, as we understand it, inevitably conceded by Mr Prosser before the FTT; and the raison d'être of article 2(15) was anyway made clear by the closing proviso of the paragraph which reads:

> "Provided, however, that the preceding provisions of this Article 2(15) shall not apply to a holding of Non-Voting Shares or any interest in Non-Voting Shares (not exceeding 10% of the issued Non-Voting Shares in total) by or for UBS Employee Benefits Trust Limited in its capacity as a trustee of any trust other than the UBS Employee Master Trust, except to the extent that this would cause the Company to be treated as an Associated Person."

138. "Associated Person" was defined as meaning an "associated company" of any Group Company, as defined in section 416 of ICTA 1988. (To avoid confusion, it should be noted that in Chapter 2 of ITEPA "associated person" has a quite different meaning from "associated company": see sections 421C and 421H(2)).

139. A similar concern that ESIP should not be treated as an Associated Person is also apparent from article 2(15)(d), which provided that any transfer, contract, declaration of trust or other arrangement relating to any NVS should be "ineffective and null and void … if the effect or result … would be to cause the Company to be treated as an Associated Person".

140. In principle, there is no reason why the rights attaching to the NVS could not have been validly restricted as provided for by article 2(15), whatever the motive for the restriction may have been. But there was a further problem for UBS. Because UBS subscribed £91.88 million for the NVS, it was essential that there should be no appreciable risk of UBS losing this sum if ESIP were to be wound up during the period of ownership of the shares by UBS. Under article 2(15) UBS would then be entitled to receive only the nominal value of the shares (£918.80), and the remaining assets of ESIP would be distributed pro rata to the holders of the ordinary shares. Since approximately two thirds of the ordinary shares were held by Mourant as trustee of the Sidemore Trust, a charitable trust unrelated to UBS, the risk was that UBS might find itself in the uncomfortable position of making an unintended donation to charity of about £60 million. Such a result, as Mr

Prosser candidly accepted in paragraph 109 of his skeleton argument, would have been commercially unacceptable.

141. Mr Prosser's answer to this point is that the risk was in practice one that UBS could safely run, because its holding of more than one third of the ordinary shares meant that it could block a special resolution in Jersey to wind up ESIP, and the prospect of a winding-up order being made on any other basis (for example pursuant to a petition on public interest grounds) was negligible. Thus article 2(15) meant what it said, and was intended by the parties to have legal effect in accordance with its terms, precisely because there was in reality no prospect that it would ever come into operation.

142. In support of HMRC's argument that article 2(15) should be disregarded, Mr Lasok relied on the decisions of the House of Lords in Street v Mountford [1985] AC 809 and Antoniades v Villiers [1990] 1 AC 417. Although neither case was concerned with tax, Mr Lasok submitted that they are authority for the proposition that the courts will disregard artificial clauses in contracts whose only purpose is to circumvent legislative provisions and disguise the true nature of the arrangements between the parties. Both cases involved attempts to avoid the application of the Rent Acts by describing as a licence a transaction which had all the legal characteristics of a tenancy. Thus the agreement in Street v Mountford was entitled "Licence Agreement", and contained a declaration signed by the occupier to the effect that she understood that the agreement did not give her a tenancy protected under the Rent Acts. Nevertheless, it was held that the agreement created a tenancy, because that was the true legal effect of the grant of a right to occupy residential accommodation for a term at a rent with exclusive possession, the grantor providing neither attendance nor services. The only reasoned speech was delivered by Lord Templeman. At 825D to 826A he commented with disapproval on the decision of the Court of Appeal in Somma v Hazelhurst [1978] 1 WLR 1014, where a young unmarried couple occupied a double bedsitting room for which they paid a weekly rent, but the landlord had insisted that they enter into separate agreements, reserving the power to determine each agreement separately, and had also required each of them to sign an agreement to share the room in common with such other persons as the landlord might from time to time nominate. Lord Templeman said at 825F:

> "The sham nature of this obligation would have been only slightly more obvious if H and S had been married or if the room had been furnished with a double bed instead of two single beds … The room was let and taken as residential accommodation with exclusive possession in order that H and S might live together in undisturbed quasi-connubial bliss making weekly payments. The agreements signed by H and S constituted the grant to H and S jointly of exclusive possession at a rent for a term for the purposes for which the room was taken and the agreement therefore created a tenancy. Although the Rent Acts must not be allowed to alter or influence the construction of an agreement, the court should, in my opinion, be astute to detect and

frustrate sham devices and artificial transactions whose only object is to disguise the grant of a tenancy and to evade the Rent Acts."

143. A similar issue arose in the Antoniades v Villiers, where by separate but identical agreements the landlord granted a young man and his girlfriend the right to occupy a top floor flat. The agreements were expressed to be licences, to which the Rent Acts did not apply, and recited that "the licensor is not willing to grant … exclusive possession"; the use of the rooms was said to be "in common with the licensor and such other licensees or invitees as [he] may permit from time to time to use the said rooms". Following its earlier decision in Street v Mountford, the House of Lords unanimously held that the shared occupation clause in the agreements was a pretence, and the real intention had been to grant exclusive possession of the flat. Thus Lord Jauncey said at 476H:

> "In all these circumstances I am driven to the conclusion that the parties never intended that clause 16 should operate and that it was mere dressing up in an endeavour to clothe the agreement with a legal character which it would not otherwise have possessed. It follows that it should be treated pro non scripto."

To similar effect, Lord Templeman said at 462E:

> "Clause 16 was not a genuine reservation to Mr Antoniades of a power to share the flat and a power to authorise other persons to share the flat. Mr Antoniades did not genuinely intend to exercise the powers save possibly to bring pressure to bear to obtain possession. Clause 16 was only intended to deprive Mr Villiers and Miss Bridger of the protection of the Rent Acts."

See too per Lord Oliver at 468B-C and Lord Bridge at 454.

144. It is also worth noting what Lord Templeman said at 462H about his earlier observations in Street v Mountford at 825 (in the passage cited above):

> "It would have been more accurate and less liable to give rise to misunderstandings if I had substituted the word "pretence" for the references to "sham devices" and "artificial transactions".

At 463C, he said that Street v Mountford reasserted three principles:

> "First, parties to an agreement cannot contract out of the Rent Acts. Secondly, in the absence of special circumstances, not here relevant, the enjoyment of exclusive occupation for a term in consideration of periodic payments creates a tenancy. Thirdly, where the language of licence contradicts the reality of lease, the facts must prevail. The facts must prevail over the language in order that the parties may not contract out of the Rent Acts. In the present case clause 16 was a pretence."

145. On the strength of these cases, Mr Lasok submitted that article 2(15) was an artificial device which UBS never intended to be acted upon, and which was only inserted into the articles of ESIP to prevent UBS from being perceived as having control over the company while it held the NVS. Article 2(15) should accordingly be ignored when determining whether or not UBS had control of ESIP.

146. Before the FTT, Mr Lasok also submitted that his argument under this head was akin to the approach adopted in the Ramsay v IRC [1982] AC 300 line of tax cases, but because of the focus on the articles of a company rather than a question of statutory construction, he argued that Antoniades v Villiers provided a closer analogy: see the decision of the FTT at [126].

147. The first question that the FTT had to decide was whether HMRC should be permitted to advance a sham argument at all, as the issue had not been raised in their statement of case. The FTT considered that the argument was admissible, in so far as it was an argument about how the law should be applied to the facts in evidence: see [127]. No complaint is now made by UBS about that direction. The FTT then stated its conclusion, as follows:

> "128. The tribunal confirms that it does not regard any aspect of the articles of association of ESIP Ltd as involving any fraud (in the *Snook* sense or any other sense). It finds that Article 2(15) of those articles was a genuine provision in the articles properly accepted by the shareholders of the company by special resolution on 26 01 2004. It was not argued that the article was beyond the powers of the company or in any other way invalid as a matter of company law. It finds that the only scope for operation of that article was in the period of not more than a day between the acquisition of the NVS by Juris Limited as nominee for UBS on 28 01 2004 and the transfer of the beneficial interests in those shares by UBS to named employees the following day. It does not accept, on the facts, that the provision was one to which the decision in *Antoniades* – that this was not a provision on which the parties intended to act – applies as it sees no basis in the evidence on which to form the view for which Mr Lasok QC contended that the parties would have ignored Article 2(15) if the circumstances that triggered it had come about. The tribunal therefore takes Article 2(15) into account in its decision that UBS did not control ESIP Ltd at any time."

148. It can be seen, therefore, that the FTT accepted Mr Prosser's argument about the reality of article 2(15): the provision was a genuine one, validly adopted, and it would have applied in the unlikely event that it was ever triggered. In other words, UBS intended to incur a real, but infinitesimal, risk of losing £60 million, as the price for ensuring that it would not have control over ESIP during its brief period of ownership of the NVS. This was not a case where the language contradicted the reality.

149. We are not surprised that Mr Lasok's primary way of putting this argument was rejected by the FTT. Article 2(15) was not a pretence in the same way that the ostensible provisions for sharing of occupation in Street v Mountford and Antoniades v Villers were, and in our view the FTT was clearly entitled to find that article 2(15) was genuine and intended to have legal effect in accordance with its terms. But with a slight change of focus, it seems to us that the argument can be made to look far more persuasive. The scheme as a whole was designed by UBS and its advisers as a way of paying bonuses in the form of restricted securities. To that end, it was essential that the NVS should carry the full economic value (or virtually the full economic value) of ESIP when they were awarded to the employees. This was achieved by giving the NVS the rights set out in article 2(7) to (14). But for article 2(15), as we have already observed, the test of control in section 416(2) would clearly have been satisfied during the brief period when the NVS were in the beneficial ownership of UBS. In terms of section 416(2)(b) and (c), UBS would then have possessed "such part of the issued share capital of the company as would, if the whole of the income of the company were in fact distributed among the participators … entitle [it] to receive the greater part of the amount so distributed", and "such rights as would, in the event of the winding-up of the company … entitle [it] to receive the greater part of the assets of the company which would then be available for distribution among the participators". Furthermore, the fact that such entitlement was intended to last for only a very short time (and probably no more than a day) would clearly have been immaterial, in view of the words "*at any other time* within one year previously" (our emphasis) in subsection (1). As Lord Hoffmann said in Newfields, the intention of Parliament was clearly to cast the net very wide.

150. In this statutory context, we ask ourselves whether it is possible, as a matter of construction of section 416(2)(b) and (c), to disregard article 2(15) on the ground that it was deliberately designed to circumvent those provisions in a way that would have been commercially unacceptable to UBS had ESIP in fact gone into liquidation while the shares were owned by UBS, and which was in practice acceptable to UBS only because the possibility of a liquidation occurring during that period was so remote that it could safely be ignored.

151. The argument is tempting, but with some regret we do not think we can yield to it. There is a clear distinction between the rights attaching to the NVS, which is a question of law to be determined by construction of the articles, on the one hand, and the likelihood of the happening of an event which would bring those rights into play, on the other hand. The sheer improbability of a liquidation occurring during UBS's period of ownership of the shares cannot, in itself, be a reason for construing article 2(15) as if it meant the opposite of what it says, or for ignoring it altogether – particularly where such a liquidation is required to be supposed by section 416 itself. Furthermore, since article 2(15) is expressed to apply *at any time* when the NVS are beneficially owned by UBS or another Group Company, there can be no basis for disregarding it for the purposes of section 416 merely because the

period of ownership was (and was always intended to be) very short. During that period, the inescapable fact is that the NVS were beneficially owned by UBS and nobody else; and the rights which attached to the NVS were those in article 2(15), not those in article 2(7) to (14). Application of section 416(2) to this state of affairs produces the result that UBS did not control ESIP, and in agreement with the FTT we would so hold.

Conclusion

152. The result of our analysis is that the exemption in section 429 applied, with the consequence that there was no charge to income tax under the detailed provisions of Chapter 2 either on the acquisition of the NVS by the employees or when the Restricted Period came to an end. This was of course the result that the scheme was designed to achieve. Subject to HMRC's broad Ramsay argument, to which we will now turn, we consider that the scheme was technically sound and produced the fiscal results which it was planned to produce.

The broad Ramsay argument

153. In paragraphs [130] to [140] of its decision, the FTT examined the scheme as a whole and concluded that, in reality, it could not properly be described as one providing restricted securities within the scope of Chapter 2. Accordingly, the facts viewed as a whole fell outside Chapter 2 altogether. The reasoning which led the FTT to this conclusion proceeded as follows.

154. First, the FTT directed itself by reference to the guidance given by Arden LJ (with whom Keene and Sullivan LJJ agreed) in Astall v Revenue & Customs Commissioners [2009] EWCA Civ 1010, [2010] STC 137, about the current state of jurisprudence on the interpretation of tax statutes, including in particular her statement (at [44]) that the second stage in applying a purposive interpretation of the relevant statutory provisions is

> "to consider whether the transaction against the actual facts which occurred fulfils the statutory conditions. This does not, as I see it, entitle the court to treat any transaction as having some nature which in law it did not have but it does entitle the court to assess it by reference to reality and not simply to its form."

155. Secondly, the FTT referred to its own earlier analysis of the object of Chapter 2 in paragraphs [51] to [54]. That analysis concludes with the following passage, which both sides before us were content to accept as correct:

> "54. The tribunal therefore takes the view that the purpose of each provision in Chapter 2 is to be derived from the context of the chapter as a whole. The purpose is to make provision that, unless the employer and employee jointly decide otherwise, and subject to defined exceptions, amounts derived from securities that are within the definition of restricted securities are to be charged to income tax not on acquisition by an employee (as the underlying rules of income tax

> provide) but on the occurrence of a later chargeable event, rather than being charged to capital gains tax on disposal by the employee. The tribunal does not consider it relevant to its interpretation and application of Chapter 2 that an individual who acquires assets that fall within Chapter 2 can, subject to entirely separate capital gains tax provisions, claim exemption from capital gains tax on disposal of those assets in certain circumstances."

156. The FTT then turned to the "actual facts" against which the statutory code in Chapter 2 had to be tested. Paragraph [134], which we have already quoted in paragraph 2 above, summarises the fiscal attractions of the scheme. This is amplified in the two following paragraphs, in terms very similar to those employed by the FTT in its discussion of the restricted securities issue. There is the same emphasis on the similarity of the eventual financial outcome, whether or not the trigger event occurred, and on the deliberate engineering of a small "loss" in the latter eventuality. The FTT also found "as fact", in paragraph [136], that it was "artificial to ignore the purchase of the options when viewing the Scheme as a whole". If the benefits to be derived from the options were taken into account, "then there was, in real terms, no significant loss of market value to be suffered by the employees as a result of the restriction".

157. Paragraph [137] contains the FTT's assessment of the reality of the scheme:

> "137. The reality is therefore as follows. Had the Scheme – or any other arrangement – not been in place, employees would have received as part of their pay in February 2004 a bonus amount determined by reference to receipts in 2003. That bonus would have been earnings. It would have been subject to deduction of income tax and NI contributions in the usual way under the PAYE Regulations, leaving in most cases a net sum of 59% of the original entitlement … Under the Scheme, employees received, about a month after the February pay arrangements …, beneficial interests in shares with a right to encash the beneficial interests. If the rights were encashed, employees received the same sums as would have been received as earnings, but without any deduction of income tax or NI contributions. Alternatively, employees might less probably receive a lump of slightly less than that sum, but again with no deduction of income tax or NI contributions. There would then be a charge to capital gains tax, at the relevant rate, but no charge to NI contributions."

158. We observe at this point that this assessment of the "reality" of the scheme amounts to little more than another restatement of its intended fiscal purpose. It is also inaccurate in one important respect. The scheme did *not* provide for employees to receive the "same sums" on redemption of the NVS as they would have received as earnings, because of the requirement (duly implemented) for the subscription monies to be invested in the purchase of

UBS shares. The amount received on redemption was therefore linked to the value from time to time of the UBS shares; and for the substantial number of employees who held their NVS until the second or third redemption dates, the amount received bore no relation to the cash value of the original bonus: see paragraph 53 above.

159. In paragraph [138] the FTT considered the purpose of the scheme, and found that "the predominant reason" for it was the mitigation of income tax and NICs. The FTT took the view that any other benefit from the scheme, such as the improvement of employer/employee relations, was purely incidental and flowed from the expected tax benefits. These are findings of fact which the FTT was clearly entitled to make, and they are not challenged by Mr Prosser.

160. The FTT then stated its conclusions:

> "139. In other words, the Scheme delivered all employees within it a significant gain in the actual cash bonus receivable as compared with the receipt of earnings, whatever the outturn of the Scheme arrangements, although there was a possibility of an insignificant loss as between the outturns under the probable and improbable alternative outturns of the Scheme. Further, if employees so chose, the timetable of the arrangements was much the same as applied to the receipt of earnings. The tribunal does not consider that, in reality, the Scheme can be properly described as one providing restricted securities within the scope of Chapter 2 of Part VII [sic] of ITEPA.
>
> 140. The tribunal therefore takes the view that [UBS] fails in this appeal by reference to the application of Chapter 2 of Part 7 of ITEPA to the facts of the Scheme as a whole."

161. With all due respect to the FTT, we are bound to say that we find its reasoning on this part of the case very difficult to follow. In paragraph [95] the FTT found that the NVS were real shares, some of which were held by employees for more than two years, and real dividends were paid on them. The FTT therefore accepted that the NVS were "securities", which in that context must mean securities within the meaning of Chapter 2, and said that the "more significant question" was whether they were restricted securities. The FTT then went on to hold (wrongly, in our view) that they were not restricted securities. But if the NVS were securities within the meaning of Chapter 2 – and the contrary seems to us unarguable – how can it then be said that the scheme as a whole nevertheless falls outside the scope of Chapter 2?

162. Unless all the FTT meant was that the securities were not restricted securities, in other words merely stating other reasons for their earlier conclusion, the only plausible basis for such a contention, in our judgment, would be if, on a realistic appraisal of the facts, the scheme was not one which

provided securities (in the form of the NVS) to employees, but one which provided them with money. By virtue of ITEPA section 420(5)(b), "money" is excluded from the definition of "securities" which applies for the purposes of Chapters 1 to 5. We readily accept that, in an appropriate case, it might well be possible to construe "money" in this context purposively, and to treat the exception as applying to arrangements which, viewed realistically, are no more than disguised or artificially contrived methods of paying money to employees. There is plenty of authority for applying a Ramsay approach (in the sense explained by Arden LJ in Astall v Revenue & Customs Commissioners) to "money in, money out" schemes of that kind: see, for example, NMB Holdings Limited v Secretary of State for Social Security (2000) 73 TC 85 (payment of bonuses by the purchase and immediate sale of platinum sponge) and DTE Financial Services Limited v Wilson [2001] EWCA Civ 455, [2001] STC 777 (payment of bonuses through artificial trust arrangements which ended with the falling in of a contingent reversionary interest a few days after the scheme was set in motion). However, caution is needed because everything always depends on a careful scrutiny of the particular statutory provisions in issue, and it is impossible to generalise from instances where such an analysis is appropriate to a broad proposition that any tax avoidance scheme designed to turn an otherwise taxable bonus into something else, and to leave the employee at the end of the day with money in his pocket, will necessarily fail in its object. It also needs to be remembered that the mere existence of a tax avoidance motive is, in itself, irrelevant, although it may of course throw light on matters such as the commerciality of the arrangements made, or the likelihood of pre-planned events occurring.

163. The need for caution in attributing too broad a meaning to the "money" exception in section 420(5)(b) is reinforced by the fact that the definition of "securities" in section 420(1) includes debentures and other instruments creating or acknowledging indebtedness, while section 424(c) makes it clear that redeemable shares are also included. Thus securities which are convertible into money, and a wide range of securities which create, evidence or secure indebtedness, plainly fall within the scope of Part 7. Moreover, since one of the legislative purposes of Part 7 is, as Lord Walker said in Grays Timber at [7], to eliminate opportunities for unacceptable tax avoidance, including in particular Chapters 3A, 3B, 3C and 3D, one naturally expects the definition of "securities" for the purposes of (among others) those Chapters to be a wide one, and the exceptions to it to be relatively narrow.

164. Wherever the precise boundary of the "money" exception should be drawn, it is in our opinion clear that the facts of the present case fall well outside it, and that the NVS are therefore within the definition of "securities". The real and enduring nature of the NVS, combined with the fact that nearly half of them were not redeemed for two years, makes it impossible to ignore them, or to regard them as a mere vehicle for the transfer of money. It is true that over half of the NVS were redeemed at the first opportunity, in March

2004, and it was plainly intended that this opportunity would be taken by those employees who would not in practice be liable to CGT on a disposal of the shares. But even in their case the shares were held for a period of almost two months, and because of the investment in UBS shares the amount received on redemption bore no necessary relation to the initial amount of the bonus. Furthermore, HMRC have never sought to argue that those employees who redeemed their shares at the first opportunity should be taxed differently from those who held their shares until 2006.

165. A related aspect of the matter is that the sums determined by HMRC to be due from UBS, by a determination notice issued under regulation 80 of the PAYE regulations on 13 October 2008, were tax on the gross amount paid by UBS into ESIP, not tax on the different amount eventually received by the employees when the NVS were redeemed. In our view there is no intellectually coherent way, in this case, of equating the payment in by the employer with the ultimate payment out received by the employee, and the facts are resistant to any form of high-level Ramsay analysis or reconstruction. The problems for HMRC are compounded by the fact that Chapter 2 contains a very detailed and prescriptive code for dealing with restricted securities, in the context of a Part which had as one of its main objectives the countering of tax avoidance. Experience has shown that advantage can sometimes be taken of detailed statutory codes of this general nature in a way that is resistant to a Ramsay analysis, with the result that even the most artificial of tax avoidance schemes may succeed in their object. For a recent example, which also involved a chargeable event regime although in the context of life insurance policies, see the decisions of Proudman J and the Court of Appeal in Mayes v Revenue & Customs Commissioners [2009] EWHC 2443(Ch), [2010] STC 1, affirmed at [2011] EWCA Civ 407, [2011] STC 1269.

166. In his oral submissions, Mr Lasok deployed a kaleidoscopic variety of arguments designed to persuade us, in one way or another, that the FTT's conclusion on this part of the case, if not all of the reasoning by which the FTT reached it, could and should be upheld. We admire his ingenuity, but are unpersuaded. In our judgment the FTT's conclusion was in law an impossible one, and there is no proper basis for holding that the scheme fell outside the scope of Chapter 2. It follows that we would allow UBS' appeal on this ground, as well as on the restricted securities issue.

DB: the facts

167. The DB scheme was generically similar to the UBS scheme, although (as we have already observed) it differed from it in some important respects. It was implemented in the same tax year, 2003/04. It was prepared for DB by Deloitte and Touche LLP ("Deloitte"), and was found by the FTT to be an "off

the shelf" scheme which did not derive from or develop internally within the DB group: see paragraph [106] of the decision.

168. The DB group was headed by Deutsche Bank AG. The appellant, DB, was the main employer in the UK of staff working for the group, and all the employees who participated in the scheme either were, or were for convenience assumed to be, employees of DB. As before, we will follow the FTT in using the term "employees" to include directors and other office holders.

169. The company whose role broadly corresponded with that of ESIP in the UBS scheme was a company incorporated in the Cayman Islands on 27 January 2004 under the name Dark Blue Investments Limited. The FTT called this company "DBI", but to avoid possible confusion with DB we prefer to call it "Dark Blue". Although initially resident in the Cayman Islands, Dark Blue later became UK-resident.

170. On 2 February 2004 the Memorandum and Articles of Association of Dark Blue were amended by special resolution, and a new share structure was put in place of which the central element for the purposes of the scheme was the creation of a class of 91,300 C1 redeemable shares of 35p each. These shares were intended to be restricted securities for the purposes of Chapter 2. The nature of the restriction was far simpler, and less artificial, than in UBS: article 34 provided for forfeiture of the shares if, before 2 April 2004, any individual who held or was beneficially entitled to them ceased to be employed by any DB company, or notice was given to or by that individual of termination of employment for any reason other than termination by the employer without cause, redundancy, death or disability. In other words, the shares would be forfeited if, broadly speaking, the employee either chose to resign or was dismissed for cause within a period of no more than two months. Apart from this provision for forfeiture, article 33 also provided that no C1 share could be sold or otherwise transferred in the period between 7 February and 1 April 2004 inclusive.

171. The remainder of the new share structure of Dark Blue comprised one share of US $1 (on which nothing turns), 38,042 ordinary shares of 35p each, 91,300 C2 redeemable shares of 35p each, 91,300 D shares of 35p each, and 251,078 E shares of 35p each. The FTT summarised the rights attaching to the shares in paragraph [45] of its decision as follows:

> "The core shareholding was in the ordinary share capital, with the usual rights. E shares had the same rights save that they were redeemable. Those shares were entitled to dividends as were C1 and C2 shares. Dividends were payable to the respective classes on a basis set out in the articles. This took into account any premium at which a share was issued. Because the C1 shares were issued at an extremely large premium, the practical effect was that most of the dividends were

> payable to those shares. D shares had no rights to distributions. C1 shares carried voting rights, but C2 and D shares did not."

172. The mechanism of forfeiture was set out in articles 34(a)(ii) and (b). On the happening of any of the specified events, each C1 share held by a "Terminating Employee" would be converted into and re-designated as a C2 share, which would be deemed to be issued at that time, and the Terminating Employee would then be bound to transfer such C2 shares for a nil consideration to the holders of the ordinary shares pro rata.

173. The company whose role broadly corresponded with that of Mourant in the UBS scheme was Investec Bank (UK) Limited ("Investec"), a well-known bank which the FTT found to be independent of DB. It was Investec which arranged for the incorporation of Dark Blue, and which appointed two of the three directors of Dark Blue; the remaining director was appointed by DB on 5 February 2004.

174. Deloitte's proposal for the scheme had been explained to the board of DB, considered and accepted in November and December 2003. On an unspecified date in December or early January 2004, an explanatory letter was sent by DB to relevant employees, offering them the opportunity to be considered for participation in the scheme (which at that stage was called "the EDSA plan"). Those interested were asked to complete and return an application form by 26 January. The minimum level of participation was £50,000, and the maximum was 90% of any discretionary bonus that might be awarded. Enclosed with the letter were a one page summary of the scheme, and a question and answer document which included the statement (relied on by Mr Lasok) in paragraph 1 that:

> "EDSA is a plan that allows for your non DB equity-based year-end discretionary award to be delivered to you in the form of EDSA shares."

Paragraph 24 of the same document gave the following answer to the question "What am I being asked to do now?":

> "You are being asked to express a preference before any decision is taken with respect to the implementation of the Plan and any awards made thereunder. This is not a guarantee or an indication that you will receive a discretionary award of any kind in relation to the 2003 performance year or that DB will decide to allow your participation in the Plan, if implemented. Participation in the Plan will be solely at DB's discretion and will also be subject to the conditions of the Plan itself as well as your being employed, and not serving a notice period, by a DB entity on the date of Award."

175. On a later unspecified date in January 2004, the compensation committee of DB decided on the sums to be allocated to named employees by way of bonus.

176. By 26 January 2004, which was the closing date for applications to participate in the scheme, some 300 employees had filled in and returned the necessary forms. On the next day, Dark Blue was incorporated and a Guernsey company, Walbrook Nominees (No. 6) Limited ("Walbrook"), which the FTT also found to be independent of DB, agreed with DB to act as nominee for the scheme.

177. On 29 January 2004, DB informed Walbrook of the names of the employees for whom shares were to be held beneficially under the scheme, and told Walbrook that it would shortly receive 91,300 C1 shares in Dark Blue to be held for those employees. Walbrook then executed a declaration of trust accordingly. Deloitte also notified DB that the final funding figure for Dark Blue would be £91.3 million.

178. On 2 February 2004 the Memorandum and Articles of Dark Blue were amended in the way we have described. On the same day:

(a) Investec subscribed £91.3 million in cash for the C1 shares in Dark Blue, and £87,000 for the E shares;

(b) Dark Blue appointed Investec as its investment manager until 31 July 2004 under a Portfolio Management Agreement, which allowed investment in a narrow range of low-risk "permitted assets" such as UK gilts and AAA-rated corporate bonds; and

(c) Dark Blue granted Investec a charge over its funds to secure all obligations at any time owed by it to Investec.

179. On 5 February 2004, DB subscribed for the 38,042 ordinary shares in Dark Blue, and also entered into a Shareholders' Agreement with Investec in relation to Dark Blue. Under this agreement, Investec agreed to transfer the C1 shares to Walbrook on 6 February for no consideration, but conditional upon DB paying to Investec a so-called "fee" of £92.6 million on the same date. We comment that the primary purpose of this payment must have been to reimburse Investec the £91.3 million which it had subscribed for the C1 shares, and only the balance of £1.3 million could in our view properly be described as a fee for Investec's participation in the scheme. What the parties hoped to achieve by this obfuscation is unclear.

180. Other provisions in the Shareholders' Agreement obliged Investec, as holder of the E shares, to ensure that its two nominees on the board of Dark Blue complied with certain regulatory requirements and were each resident in the UK for UK tax purposes. Investec also agreed to procure that Dark Blue

would open and operate a bank account, and a custodian arrangement for the holding of its assets, with companies within the DB group, and that it would no longer hold its funds with Investec. For its part, DB agreed to provide Investec with monthly valuations of Dark Blue's assets, on the basis of which Investec would then provide DB and Walbrook with indicative figures for redemption of the C1 shares in June, July, September and November 2004, and January, February, June, August and November in each subsequent year. The machinery for redemption was then set out, with the consequence that the first redemption date would be the sixth business day of July 2004, i.e. 8 July 2004.

181. On 6 February 2004 the arrangements set out in the Shareholders' Agreement were duly completed. DB paid £92.6 million to Investec, and Investec transferred the C1 shares to Walbrook. On the same day, Walbrook wrote to the relevant employees informing them of their awards of C1 shares, which Walbrook said it held on bare trust for them as nominee, and of the arrangements made with Investec for the investment of Dark Blue's funds.

182. As we have already noted, the period during which transfer of the C1 shares was prohibited began on 7 February and continued until 1 April 2004. On 8 July 2004 the first tranche of C1 shares was redeemed, at a price of £1,003.73 per share. As we understand it, opportunities for regular redemption then continued to be made available until December 2006, and according to the chronology annexed to the FTT's decision the final date for sale or redemption of the shares was 31 December 2009, nearly six years after the scheme was set in motion.

183. The FTT heard oral evidence of fact from three witnesses. John Berry was the only witness who was a DB employee. He was a beneficiary of the scheme, but had also assisted DB in its implementation. His position at the relevant time was as head of European execution for the Structured Capital Markets Group. The FTT found, however, that he had no executive or planning responsibility for the scheme, and was concerned with it in an administrative role only. In his own words, quoted by the FTT, "my involvement in the Transaction was a short and intense period of approximately 14 days". He stopped working for DB in 2004, apart from a continuing retainer in connection with the scheme.

184. The second witness, Roy Beddows, was a "transactor" working with Investec. He was not a willing witness for DB, and gave his evidence under summons. He confirmed that the scheme was a fee earning opportunity from Investec's point of view, and that Investec performed the role that the documents indicated it had performed. The FTT found that the only interest Investec had in the scheme was the cash fee it was paid for its involvement, and said it "heard and saw no significant evidence that Investec was asked to

exercise any independent discretion with regard to the Scheme or any investment or other expertise" (paragraph [17](b) of the decision).

185. The third witness, Sharon Parr, was a director of Walbrook. She had direct responsibility for Walbrook's relations with DB, and gave evidence about Walbrook's involvement in the scheme. The FTT found her evidence to be "fully consistent with the role of Walbrook as a nominee", and accepted her evidence that Walbrook had acted accordingly.

186. In paragraph [20], the FTT said it was "left with the feeling that the witness evidence added little to the documentation beyond an affirmation by each of the three witnesses that the documents represented what happened". The FTT also noted, in paragraph [21], the limited extent of the evidence offered by DB itself about its own involvement in the scheme. While Mr Berry's evidence as a participant in the scheme was useful and derived from personal experience, the FTT said that it "was only able to derive limited assistance from his other evidence".

187. The FTT also heard expert evidence, from Keith Eamer for DB and (as in UBS) from David Croft for HMRC. Mr Eamer had been a director in the share and business valuation department of BDO LLP, chartered accountants, and was instructed to value the C1 shares as at 6 February 2004 with particular reference to the restrictions imposed on those shares by the articles of Dark Blue.

188. In relation to the documentary evidence, the FTT recorded that it "had before it considerable documentation about the evolution and execution of the Scheme" (paragraph [22]). The FTT also saw sample communications with employees who benefited from the scheme, and was satisfied that DB had supplied HMRC with the relevant documents. One matter which the FTT found to be clear from the documentation was that the scheme had not been generated internally by DB, but was:

> "a plan put together for DB by Deloitte on the basis of a more general proposal initially put to DB. Deloitte continued throughout to play a central role in designing and delivering the scheme".

189. The FTT then referred to a draft timetable and action plan for the scheme sent by Deloitte to DB on 7 January 2004, and continued:

> "24. It is not surprising in this context, given the tribunal's views of the oral evidence presented to it, that the tribunal finds that the evidence is that the documents produced by DB, for example by way of company documents, represented what had happened stage by stage as the Scheme was put into effect. DB's case was that the critical documents

both adequately and accurately evidenced the implementation of the Scheme, in that the events took place and the parties involved in the Scheme acted in accordance with the terms of all agreements. The tribunal finds no strong evidence pointing otherwise, and accordingly accepts that submission. Some variations, for example in late signings, are to be expected and did occur, but such events tend to confirm that what happened did occur rather than the opposite. But the tribunal adds that it also finds that the parties also acted in accordance with the various timetables and action plans, and continued to revise and update these common schedules of action".

DB: the money entitlement issues

190. The arguments on these issues were very similar to those in UBS, but with the difference that none of the employees was entitled to a guaranteed minimum bonus award. The crucial dates were (a) the unknown date in January 2004 when the compensation committee of DB decided on the sums to be allocated as bonuses to the relevant employees, and (b) 6 February 2004, when the employees were notified of their awards of C1 shares, and beneficial title to the C1 shares passed straight from Investec to the employees (by virtue of the declaration of trust which Walbrook had already executed on 29 January). The former date must have been before 29 January, because by then the number of C1 shares, the names of the recipients, and the subscription price of £91.3 million had all been determined.

191. After summarising HMRC's argument that the employees must have become entitled in advance to payment of the sums which were used to acquire the C1 shares, the FTT continued as follows:

"30. Mr Goy QC resisted this argument, relying both on the oral evidence of Mr Berry and on the documentary evidence produced to the tribunal, including the staff handbook and the documentation issued to DB employees about the Scheme. DB operated on the basis that a bonus was discretionary until awarded. No individual had any advance entitlement in his or her contract of employment to any bonus, and employees knew this. Entitlement arose only when the bonus was notified or paid to the individual. In this case the first notification was that of share entitlement. Employees had indicated ahead of any knowledge of entitlement whether they wished to be involved in the Scheme. Payment for those who did not wish to be involved or who did not qualify took place separately and after the establishment of the Scheme.

31. The tribunal has little hesitation in finding that employees did not have entitlement to any sum ahead of the transfer of funds to the Scheme. While it agrees that individual sums of bonus entitlement had been identified by DB, it sees no legal basis in the evidence before it on which any individual employee could sue for that sum. It was not

paid to the employee when paid into the Scheme, and it was not received by an employee when that happened. The tribunal therefore finds as fact that none of the DB employees received any sums as earnings when the sums allocated in respect of them to the Scheme were identified or when they were paid into the Scheme. If and in so far as any sum formed earnings of an employee it is because of events on or after 6 February 2004, the date on which notification of interests in shares were sent to individual DB employees and the day after DB agreed to subscribe to the relevant shares."

192. If we are right in our views about the construction of Rule 2 in section 18(1) of ITEPA (see paragraphs 61 to 70 above), we consider that the FTT's reasoning and conclusion on this part of the case were clearly correct. The employees had no present right to present payment of the relevant part of their bonuses in money at any time before they received the beneficial interest in the C1 shares. There is no legal or logical necessity for such a finding, any more than in UBS, and the entitlement of the employees to receive any bonus was purely discretionary. This was reflected, for example, in the "expression of preference" form which employees were asked to complete and return by 26 January 2004:

> "I understand that I may, at the discretion of the Company, receive an award in respect of my services for performance year 2003 ("the Award"), but that I have no entitlement to any such Award. I understand that if I have been guaranteed an Award by any DB entity, the guaranteed Award is not eligible for consideration under this plan. I also understand that the Company is considering Awards in a variety of forms and any Award made to me may be in one form or a combination of several. (The EDSA plan described in the communications mentioned above is one of those potential Awards). … I confirm that I would like to be considered for participation to the extent of £ … For the avoidance of doubt, the expression of wishes referred to above shall only apply in relation to any non-DB equity-based discretionary Award for performance year 2003, and creates no entitlement or obligation, and is not binding in any way on the Company."

Note (3) on the form stated:

> "I understand if the Company determines to make an Award to me, then the Company has the discretion to make the Award in any form that it chooses regardless of any preference expressed by me."

193. Mr Lasok accepted that the underlying bonus system operated by DB, as reflected in the employees' contracts and terms of employment, was discretionary in form and conferred no entitlement to any particular sum on employees unless and until an award was made. He sought to argue, however, that this basic position was altered by the terms of the scheme itself, and that DB must have decided to pay specified sums by way of bonus to the relevant

employees before the expression of preference forms were taken into account and the decision was made to pay part of the bonuses in the form of C1 shares. We are unable, however, to see any proper basis for drawing such an inference, which would in our view contradict the clear language of the form. Furthermore, even if DB had taken a preliminary decision about the amount of cash to be allocated to each employee, any such decision was purely internal, and it remained subject to review in the light of the preference forms. On no view, therefore, can it have given rise to a present entitlement to payment in cash before the scheme was put into operation.

DB: were the C1 shares restricted securities?

194. The live issues before the FTT under this heading were, in outline, (a) whether the restrictions contained in articles 33 and 34 of the articles of Dark Blue were real and genuine, and (b) if so, whether the market value of the C1 shares at the date of their acquisition by DB (6 February 2004) was less than it would have been but for the provision for forfeiture in the articles, so that the condition in section 423(1)(b) of ITEPA was satisfied. In contrast with UBS, there was no issue whether the market value test in section 423(2)(c) was satisfied, because the effect of the forfeiture provision, if it applied, was that the relevant C1 shares were (via their conversion into C2 shares) disposed of for a nil consideration: see paragraph 172 above, and paragraphs [51] to [55] of the decision of the FTT where the relevant provisions in the articles are set out.

195. After reciting the rival arguments in paragraphs [58] to [60], the FTT stated its conclusions on these issues as follows:

> "61. The tribunal accepts that the C1 were real shares, and holders received actual dividends. It was possible for an employee to hold them for over two years, and some did so. If they did so, they received dividends from the sums invested in [Dark Blue] and invested by it. Those shares were securities.
>
> 62. The tribunal also accepts that the shares were securities subject to a provision within the scope of section 423(1)(a) on the relevant date by reference to Article 34. There was some argument that the restrictions were not genuine restrictions. There was, for example, the suggestion that the restriction was not genuine and that there was no real intent to apply it. The tribunal does not accept that. While the restriction in Article 34 was clearly both limited in time and scope it was nonetheless there. Nor could it be said to be so limited in time and scope together that it could be ignored as of no significance. Unless the tribunal had before it evidence that this was a sham – and it had no

such evidence – then the terms of Article 34, when looked at in isolation as a restrictive provision, are not to be ignored.

63. The next issue, also in dispute between the parties, was whether the securities were within section 423(1)(b) …

64. The tribunal had before it the evidence of two expert witnesses on this issue, Mr Eamer for [DB] and Mr Croft for [HMRC].

65. Mr Eamer's evidence was that the valuation of the shares on the relevant date would be reduced by a sum in the order of 2 to 3 per cent by reason of the restrictions, separately under article 33 and article 34. Under cross-examination he accepted that these were not benchmarked values, but that they reflected what in his view would be a preference of a purchaser to purchase without these restrictions.

66. Mr Croft's evidence was that the effect on valuation of the restriction was not of significance. Mr Goy QC took issues with some of the statements made by Mr Croft in his witness statement on the grounds that these were statements made outside his competence as an expert witness. The tribunal accepts that submission. There were matters in the report which went beyond the witness's instructions and involved the expression of views on issues that are for the tribunal to determine, in part, as questions of law. In so far as those statements can be regarded as evidence, the tribunal emphasises that it puts no weight on them. But it does take into account the more specific evidence relating to the valuation of the C1 shares on 6 February 2004. However, it accepts that the evidence of Mr Eamer was presented on a narrower basis of specialism than that of Mr Croft. While it does not accept Mr Goy QC's comment that the tribunal heard from one expert witness alone, it also takes this into account in weighing this evidence.

67. Mr Lasok QC submitted that Mr Eamer's evidence of a reduction in value of 2 to 3 per cent in respect of the effects of article 34 was a random figure and that in reality the reduction in value, properly viewed, was not sufficient to render the C1 shares as within the provisions of section 423(1)(b). Mr Goy QC in response pointed out that a small percentage of a large figure could of itself be significant. He also referred the tribunal to the views of Lord Walker about the phrase "market value" in this context in *Grays' Timber* …

68. The tribunal takes from this that it should take a non-technical view of market value for the purposes of Chapter 2, and that it should look at the evidence – in particular the evidence of Mr Eamer – with that approach in mind. On that basis, the tribunal finds that the restrictions did cause a reduction in market value for the purposes of section 423(1)(b) by reference to article 34 on 6 February 2004 even if no

regard is had to article 33. While it might be a small percentage reduction, the tribunal agrees with both Mr Goy QC and on the evidence that the restriction was not only genuine but something that would affect, and therefore must be treated as affecting, the market value of the C1 shares on that date. It was not a negligible effect that could be ignored.

69. It follows from this that, leaving aside for the time being the arguments of Mr Lasok QC about the Scheme as a whole, the C1 shares held by Walbrook for the DB employees entitled under the Scheme were restricted securities within the meaning of Chapter 2 of Part 7."

196. In our judgment there is no error of law in the conclusions of the FTT on these issues. The FTT was plainly entitled to find that the provisions in articles 33 and 34 were genuine and intended to take effect in accordance with their terms; and Mr Lasok did not seek to argue the contrary before us. The FTT also had well in mind the fact that the only restrictions which applied on 6 February were those in article 34, because the prohibition on transfer in article 33 did not come into operation until the following day. While that is true, we would comment that the existence of the restriction in article 33 was still clearly relevant to the market value of the shares on the previous day. The FTT assessed the likelihood of a forfeiture taking place, and concluded that it could not be ignored as of no significance, despite the obvious limitations in time and scope of the triggering events. The FTT might have added (as counsel for DB submitted to us in their skeleton argument) that restrictions of this nature are clearly within the contemplation of section 423, because section 424(b) provides an express exception to the effect that employment-related securities are not restricted securities by reason only that the holder may be required to offer them for sale or transfer them "on the employee ceasing, as a result of misconduct, to be employed by the employer or a person connected with the employer". There would be no need for the exception, so the argument runs, unless provisions for forfeiture of the shares on cessation of employment were within the scope of section 423. Equally, the exception shows that it does not matter if the triggering event is one within the control of the employee.

197. Section 423(3)(a) applies to the securities only if there is a provision under which there will be "transfer, reversion or forfeiture". The mechanism by which the employees were to lose the C1 shares consisted of their conversion to C2 shares and the immediate transfer of those shares for no consideration. The C1 shares were different from the C2 shares and there is no provision in Chapter 2 which equates them on conversion. Thus the transfer of the C2 shares would not be a transfer of the securities for the purposes of section 423(3)(a). It plainly would not be a reversion. But in our judgement the process by which the employees were to be stripped of the C1 shares if

they gave notice to terminate their employment is within the meaning of "forfeiture" in section 423(3)(a).

198. In relation to section 423(1)(b) itself, the only relevant requirement is that the market value of the securities should be "less" than it would be but for the forfeiture provision. There is no requirement of a minimum reduction in value, and we can see no basis for importing one unless the reduction in value is so small as to be truly insignificant. In such circumstances, there is no obvious reason why Parliament should have wished to bring the securities within the scope of Chapter 2 and to eliminate an Abbott v Philbin charge on their acquisition by employees. Conversely, if there was a significant reduction in market value, however small, there was every reason to include the securities within the scope of Chapter 2, with a view to ensuring that a charge to tax on the full market value of the shares would arise on the happening of a chargeable event.

199. The question whether the reduction in value brought about by the forfeiture provision in article 34, and the restriction on transfer in article 33, was so small as to be insignificant was in our judgment one of fact and degree for the FTT to determine. The FTT was entitled to prefer the expert evidence of Mr Eamer to that of Mr Croft, and to accept that the reduction in value was not negligible. Mr Lasok sought to persuade us to the contrary, by reference to the transcript of Mr Eamer's cross-examination, but we remain wholly unpersuaded that this conclusion was an impossible one for the FTT to reach. Whether we would have reached the same conclusion ourselves is beside the point. Furthermore, common sense suggests that even a very remote chance of forfeiture is likely to have a depressing effect on market value, given that the shares would in effect then have to be transferred for a nil consideration. In some contexts a reduction in market value of the order of 2 to 3 per cent might well be negligible, but we do not think the present context can be so categorised. After all, as Mr Goy pointed out, even 2% of the unrestricted market value of the C1 shares would be about £1.8 million, and some of the largest share awards to individual employees were in excess of £2 million (where a 2% reduction in value would amount to £40,000). Even at the minimum award level of £50,000, the reduction would be £1,000. These are not negligible amounts, and in our view the FTT was entitled to find that the C1 shares were restricted securities within the meaning of Chapter 2.

DB: the control issue

200. As in the case of UBS, it was common ground that a chargeable event under section 426 occurred when the C1 shares ceased to be restricted securities on 2 April 2004. Everything therefore turned on the availability of the exemption in section 429, and (again as in UBS) the key issue was whether, immediately before the chargeable event, DB was an "associated company" of Dark Blue within the meaning of section 429(4)(d). As we have

explained, the answer to this question depends on application of the test of control in section 416 of ICTA 1988, and for this purpose "control" means control at shareholder level: see paragraphs 114 to 124 above.

201. It is necessary at this point to say a little more about the complex shareholding structure of Dark Blue. We take the following details mainly from the appendix to the skeleton argument of counsel for DB.

(a) The C1 shares ranked with the ordinary shares and the Class E shares with regard to a preferential dividend equal to 90% of the distributable profits of the company, on terms that the distribution of the dividend was to be made according to the nominal value of the shares, but with the nominal value of the C1 shares increased by the share premium account of the company at the record date (article 5(a) and (b)). The shares carried one vote per share on a poll (article 6). They were redeemable in certain circumstances (article 7). On a winding-up, the holders were entitled to repayment of capital paid up plus (after repayment of capital on other issued shares) the first £105 million of surplus assets to be divided between all C1 and C2 shares in issue. The C1 shares, as we have said, were issued to Investec on 2 February 2004 for £91.3 million. No C2 shares were ever issued.

(b) The E shares carried the dividend rights mentioned above, and also carried one vote per share on a poll and were redeemable by the company in certain circumstances. On a winding-up, they carried the right to repayment of capital subscribed, and then ranked pari passu with the ordinary shares but only after payment of the first £105 million of surplus assets to the C shareholders. The E shares were issued to Investec on 2 February 2004 for £87,377.30.

(c) The ordinary shares had the dividend rights mentioned above, and also carried one vote per share on a poll. On a winding-up, they had the same rights as the E shares. On 5 February 2004, 38,042 ordinary shares were issued to DB for £13,314.70.

202. The total number of shares in issue was therefore 380,420, all of which had equal voting rights. DB held 10% of the shares, in the form of the ordinary shares, while Investec held 66%, in the form of the E shares. The C1 shares accounted for the remaining 24%, and were beneficially held by Investec during the short period between their issue on 2 February 2004 and their transfer to Walbrook as nominee for the employees on 6 February. The effect of the provisions relating to dividends and distribution of assets on a winding-up was, of course, that the C1 shares in practice represented almost the entire economic value of the company. In terms of voting control, however, at shareholder level, Investec prima facie had a controlling interest throughout. Nor was there ever any formal agreement between Investec and any DB company as to how Investec should exercise the votes it held in

respect of the C1 or E shares. Similarly, there was no such agreement between Walbrook and any DB company in respect of the C1 shares after 6 February 2004.

203. Against this background, the FTT was clearly right to find (paragraph [88] of the decision) that DB "at no time had control of [Dark Blue] in the formal sense of being a controlling shareholder of [Dark Blue]". The FTT continued:

> "Nor does it find the argument that the tribunal can ignore the E shares, or any other class of shares, is one carrying any weight. On the contrary. The whole arrangement revolved around the complicated share structure and the precise terms on which the various classes of shares were issued.
>
> 89. It is that feature – the carefully engineered share structure of [Dark Blue] – that, in the view of the tribunal, is at the heart of this aspect of the argument. It is certainly not to be ignored either selectively or as a whole."

We agree, but, as the FTT also rightly recognised, that is not the end of the argument. It is also necessary to consider whether DB in fact exercised control at shareholder level over Dark Blue, despite the fact that it was only a minority shareholder.

204. The FTT dealt with this question in paragraphs [90] to [97], as follows:

> "90. It is clear to the tribunal that Investec and [Dark Blue] (initially in the guise of Newco) were written into the planning and implementation of the Scheme in a detailed, indeed prescriptive, way. Investec was to take certain actions at certain times and [Dark Blue] was to take other actions at certain times. Why? Because that was required to implement the Scheme. The evidence of the planning clearly points to both Investec and [Dark Blue] being guided closely about what they had to do and when they had to do it. Was that guidance – the tribunal's term – enough to constitute control ahead of any formal agreement? The tribunal has in mind the evidence showing that the timing of, and the order in which, events occurred, including the order in which the agreements between DB and both [Dark Blue] and Investec occurred, was a preordained order.
>
> 91. That is the factual situation, the tribunal finds, to which it must apply the test in section 416: "a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs".
>
> 92. [*The FTT then quoted from the decision of the Special Commissioner, Dr John Avery Jones, in* <u>*Foulser v MacDougall*</u> *[2005] STC (SCD) 374 at [26], where he concluded that the actions of Mr*

Foulser on behalf of himself and his wife "went far beyond just acting as a director negotiating a sale and making a recommendation to the shareholder of the underlying companies", and that Mr Foulser "made all the decisions relating to the sale".]

93. That form of wording reflects the facts of that case, which the tribunal does not need to elaborate here. And, of course, this is not binding guidance. But the Special Commissioner had had the case law mentioned above cited to him: *Arrowtown*, *Gascoigne* and *Newfields*. This tribunal adopts that approach as a practical test on the facts with which to approach the features of this appeal just rehearsed. Standing back, did those go beyond mere negotiation and recommendation? Did DB make all the decisions relating to the Scheme to the extent that it controlled [Dark Blue] either alone or in co-operation with Investec?

94. The tribunal finds that the evidence shows close co-ordination, but does not, in the section 416 sense, show control.

95. The tribunal has indicated in the findings made above its view about the levels of agreement and co-ordination occurring between those involved in establishing the Scheme. It is clear that Investec knew that to earn the full fee the Scheme had to proceed in a particular way and to a particular timetable. And it is clear that [Dark Blue], controlled by Investec, emerged from this process and conducted itself as required by the process.

96. The tribunal also observes that the evidence produced to it of the involvement of Investec is limited. It saw notes of the meetings of 15 and 19 January. But it did not see evidence of any email exchanges equivalent to those it saw between DB and Deloitte. For example, the tribunal has set out above evidence of a request by Christine Chen of Deloitte that John Berry of DB ask Investec to ask Walbrook to take certain actions. This suggests ongoing email exchanges. But the tribunal does not consider that it can read into that evidence – or absence of evidence – the necessary degree of compulsion as between DB and [Dark Blue] that would amount to control for these purposes. It does not show that DB's actions went "far beyond" those of a commercial entity dealing with another commercial entity to the extent that in reality [Dark Blue], and therefore Investec, was not in control of its own decisions.

97. Accordingly, the tribunal finds that there was no control in the section 416 meaning of the phrase and that this aspect of Mr Lasok QC's argument fails."

205. In considering these findings, we would first observe that the reference in paragraph [96] to "the necessary degree of compulsion" seems to us to set

the bar for the test of control significantly too high. A person can in our judgment exercise control over another, without being in a position to *enforce* compliance, if the other can in practice be relied upon always to act in accordance with his wishes and without giving any independent thought to it. This is the kind of control that "shadow" directors are accustomed to exercise at board level, and we see no reason why similar principles should not apply at shareholder level too. Moreover, the point is perhaps even clearer when two or more persons together exercise or are able to exercise direct or indirect control over a company's affairs. Such combined activity or ability to exercise control is brought within the scope of section 416 by subsection (3). We have already quoted from the judgment of Chadwick LJ in Foulser v MacDougall (see paragraph 132 above) where, in relation to the similar test in section 839(7) of ICTA 1988 of acting together to exercise control of a company, he said that "the concept is sufficiently wide to include cases where one person (who has shareholder or voting control) agrees to exercise that control in accordance with the wishes of another". In our view, therefore, two central questions which the FTT should have asked itself were (a) whether Investec (as the shareholder with voting control of Dark Blue) had agreed to exercise that control in accordance with the wishes of DB, and (b) whether at shareholder level DB was in practice always able to rely upon Investec to act unthinkingly in accordance with its wishes. In either case, the correct conclusion of law would have been that the test of control in section 416(3) was satisfied. It is also necessary to remember that it would have been enough for the test to be satisfied *at any time* after Investec first acquired shareholder control of Dark Blue by its subscription for the C1 and E shares on 2 February 2004.

206. On 5 February 2004 Investec and DB entered into the Shareholders' Agreement. We have already referred to some of its main provisions in paragraphs 179 to 180 above. As the name of the agreement itself indicates, this was an agreement entered into between the two companies as shareholders: so it was clearly the kind of agreement to which section 416 could apply. Furthermore, the obligations undertaken by Investec under the agreement all formed part of the preordained scheme which Deloitte had masterminded for DB. There was no independent input from Investec at all. We have already referred in paragraph 184 to the FTT's important findings that Investec had no interest in the scheme apart from the cash fee paid for its involvement, and that it never exercised any independent discretion with regard to the scheme. In other words, in return for a handsome fee Investec agreed to play a preordained role in a tax avoidance scheme devised for DB by Deloitte. That the scheme was indeed preordained in all material respects appears not only from paragraph [90] of the decision but also from numerous other findings, notably in paragraphs [108] to [112]. So, for example, the FTT said in paragraph [111]:

> "Further, although the Scheme was undertaken through the medium of independent entities, the tribunal finds as fact that in reality the whole was a coordinated scheme in which all those involved in providing bonus payments to the employees played assigned roles undertaken

either to achieve the desired reduction in taxation or to receive a fee for facilitating that aim".

207. In the light of these findings, the conclusion appears to us inevitable. The activities of Investec as majority shareholder of Dark Blue, including in particular its entry into the Shareholders' Agreement, were dictated to it by DB, not as a matter of legal compulsion, but simply because this was what Investec in practice had to do in order to earn its fee, and because Investec never brought any independent thought or judgment to bear in the fulfilment of its preordained role. Investec acted throughout in accordance with the wishes of DB, and there was never any realistic possibility that it would do otherwise. In those circumstances, it seems to us to follow that DB and Investec together both exercised, and were able to exercise, direct control of Dark Blue within the first limb of section 416(2) read with subsection (3). For the same reasons, we consider that DB alone in practice had the ability to exercise direct or indirect control over Dark Blue at shareholder level.

208. If the FTT had not misdirected itself by importing a requirement of compulsion as between DB and Dark Blue, we think that the only answer it could properly have given to the question which it asked itself at the end of paragraph [95] was an affirmative one. DB did indeed make all the decisions relating to the scheme, whether directly or through the agency of Deloitte who devised the scheme on DB's behalf; and it controlled Dark Blue, either alone or in conjunction with Investec, because (as the FTT in effect found) Investec was a mere cypher which unthinkingly did whatever it was asked to do in order to earn its fee. The crucial distinction between the findings of fact which the FTT made in relation to the role of Mourant in UBS and those which it made in relation to Investec in DB is that in the UBS case the FTT did not make findings similar to those we quote in paragraphs 204 and 184 from which it was plain that Investec would do what was expected of it in order to earn its fee without exercising any independent discretion. In the absence of such findings the presumption must be that Mourant as trustee of a charitable trust would not have ceded control to a co shareholder (see paragraph 131). Another distinction is that the Shareholders' Agreement had no parallel in UBS, and most of the activities of ESIP relied on by HMRC as showing control by UBS were activities at board level.

209. On behalf of DB, Mr Goy QC submitted that shareholder control of Dark Blue by DB, or by DB in conjunction with Investec, was not established merely because Investec predictably decided to act in accordance with its own financial self-interest. But it seems to us that the FTT's findings of fact go considerably further than that, and negate any true independence on the part of Investec at all.

210. In our respectful opinion, the FTT erred in law in finding that the test of control in section 416 was not satisfied, and its decision on the point cannot

stand. It follows that the exemption under section 429 of ITEPA was not available, the scheme failed in its object, and DB's appeal must be dismissed.

DB: the broad Ramsay argument

211. In view of the conclusion which we have reached, we can deal with this very briefly. On the basis of an analysis similar to that which it undertook in UBS, the FTT accepted HMRC's argument that the scheme fell entirely outside the scope of Chapter 2. For essentially the same reasons as those which we have given for rejecting the corresponding submission in UBS, we respectfully consider that the FTT's analysis pushes the Ramsay principle well beyond permissible bounds. In particular, we are satisfied that the C1 shares were "securities" within the meaning of Chapter 2, that the scheme cannot be re-characterised as one for the payment of money, and that there is no legitimate process of construction of Chapter 2 (either as a whole or in its relevant constituent parts) which can lead to the conclusion that it is inapplicable to the facts of the present case.

212. Accordingly, we would have allowed DB's appeal on this ground, and, had we not differed from the FTT on the "control" issue, we would have held that the scheme succeeded and DB's appeal must be allowed. In the event, however, for the reasons which we have given in relation to the "control" issue, DB's appeal will be dismissed.

The Hon Mr Justice Henderson

Judge Charles Hellier

TRIBUNAL JUDGES
RELEASE DATE: 17 September 2012