[2018] UKUT 0130 (TCC)

Appeal number: UT/2017/0070

CAPITAL GAINS TAX – unapproved employee share options – grantor having discretion on exercise of option to satisfy option holder's entitlement either by transfer of shares or payment of cash – whether s 144ZA TCGA disapplies the market value rule in s 17(1) TCGA

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

BETWEEN:

STEPHEN DAVIES

Appellant

- and –

THE COMMISSIONERS FOR
HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

Tribunal: Mr Justice Zacaroli
Upper Tribunal Judge Berner

Sitting in public in London on 26 March 2018

Sarah Black, counsel, instructed by Smith & Williamson LLP, for the Appellant

Akash Nawbatt QC, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. Mr Stephen Davies, the Appellant, has been employed by the Goldman Sachs Group ("GS") since 1993. He became a managing director in 2006. In 1999 and 2000 he was granted unapproved employee share options by GS. He exercised the options, in three tranches, in 2005 and 2006, receiving shares which were on each occasion immediately sold by him.

2. Following the exercise of the options, and after taking legal advice, Mr Davies filed tax returns on the basis that the exercise of the options gave rise to allowable losses. He did so on the following bases. First, that the market value rule (found in s 17(1) of the Taxation of Chargeable Gains Act 1992 ("TCGA")) applied, because s 144ZA TCGA (which disapplies the market value rule in the case of certain options) itself did not apply. Second, that pursuant to HMRC guidance issued in 2003, the acquisition cost of the option shares was the sum of their market value and any amount charged to income tax on the exercise.

3. Mr Davies used these losses to set against capital gains in 2005/6, 2006/7, 2007/8 and 2010/11. Enquiries were opened by the Respondents ("HMRC") into Mr Davies' tax returns and closure notices and amendments to self-assessments for each of the relevant years were issued on 17 February 2016. Mr Davies appealed to HMRC and a review decision, confirming the amendments, was issued on 7 June 2016. Mr Davies appealed to the First-tier Tribunal ("FTT") on 23 June 2016. In a decision dated 17 February 2017 the FTT (Judge John Walters QC) dismissed the appeal.

4. Two issues were raised before the FTT. The first was whether s 144A TCGA (cash-settled options) applied to the exercise of the options. The FTT found (in Mr Davies' favour) that it did not. There is no appeal against that decision. The second was whether s 144ZA applied, so as to disapply the market value rule in respect of the options. The FTT found (in favour of HMRC) that it did. Mr Davies appeals that decision, with the permission of the FTT.

Summary of the facts

5. The options were granted to Mr Davies under an unapproved employee share option scheme known as the Goldman Sachs 1999 Stock Incentive Plan. This was a US incentive plan, designed to attract, retain and motivate officers, directors and employees. It was governed by New York law.

6. The options were over quoted shares in the Goldman Sachs Group Inc, whose shares are listed on the New York Stock Exchange and NASDAQ.

7. By paragraph 6 of the Option Award, upon receipt of the exercise price, delivery of the option shares was to be effected by book-entry credit to the employee's custody account maintained with Chase Manhattan Bank, or such successor custodian designated by GS. Once credited to the account, the shares would belong beneficially to the employee. GS had the right, however, to deliver cash in

lieu of all or any portion of the shares otherwise deliverable in accordance with that paragraph of the Option Award.

8. The existence of a discretion in GS to deliver cash in lieu of shares was also made clear in a document provided to Mr Davies entitled "Award Summary; 2000 Year-End Restricted Stock Unit Award and 2000 Year-End Stock Option Award."

9. Mr Davies exercised the options in three tranches, on 20 October 2005 (in respect of 2,800 shares), on 13 January 2006 (in respect of 2,863 shares) and on 30 March 2006 (in respect of 1,605 shares). On each occasion, the shares that he received were sold on the market on the same day, such that the fair market value and the sale price of the shares was the same. Mr Davies filed returns on the basis that s 144ZA did not apply and that, on the basis of HMRC guidance at the time (which we refer to in more detail at paragraph 25 below), the acquisition cost of the shares was equal to the aggregate of (a) the market value of the shares at the time of the exercise of the option and (b) the amount charged to income tax on the exercise. This resulted in a claimed allowable loss of £302,294.

Legislation

10. Share options are governed, for CGT purposes, by Chapter 3 of Part 4 of TCGA. At the relevant time, the relevant provisions were as follows.

> **Section 144**
>
> "(1) Without prejudice to section 21 [general provisions concerning assets and disposals], the grant of an option, and in particular—
>
> (a) the grant of an option in a case where the grantor binds himself to sell what he does not own, and because the option is abandoned, never has occasion to own, and
>
> (b) the grant of an option in a case where the grantor binds himself to buy what, because the option is abandoned, he does not acquire, is the disposal of an asset (namely of the option), but subject to the following provisions of this section as to treating the grant of an option as part of a larger transaction.
>
> (2) If an option is exercised, the grant of the option and the transaction entered into by the grantor in fulfilment of his obligation under the option shall be treated as a single transaction and accordingly-
>
> (a) if the option binds the grantor to sell, the consideration for the option is part of the consideration for the sale, and
>
> (b) if the option binds the grantor to buy, the consideration for the option shall be deducted from the cost of acquisition incurred by the grantor in buying in pursuance of his obligations under the option.
>
> (3) The exercise of an option by the person for the time being entitled to exercise it shall not constitute the disposal of an asset by that person, but, if

an option is exercised then the acquisition of the option (whether directly from the grantor or not) and the transaction entered into by the person exercising the option in exercise of his rights under the option shall be treated as a single transaction and accordingly-

(a) if the option binds the grantor to sell, the cost of acquiring the option shall be part of the cost of acquiring what is sold, and

(b) if the option binds the grantor to buy, the cost of the option shall be treated as a cost incidental to the disposal of what is bought by the grantor of the option.

…

(5) This section shall apply in relation to an option binding the grantor both to sell and to buy as if it were 2 separate options with half the consideration attributed to each.

(6) In this section references to an option include references to an option binding the grantor to grant a lease for a premium, or enter into any other transaction which is not a sale, and references to buying and selling in pursuance of an option shall be construed accordingly."

Section 144ZA

"(1) … this section applies where–

(a) an option is exercised, so that by virtue of section 144(2) or (3) the grant or acquisition of the option and the transaction resulting from its exercise are treated as a single transaction, and

(b) section 17(1) ("the market value rule") applies, or would apply but for this section, in relation to–

(i) the grant of the option,

(ii) the acquisition of the option (whether directly from the grantor or not) by the person exercising it, or

(iii) the transaction resulting from its exercise.

(2) If the option binds the grantor to sell–

(a) the market value rule does not apply for determining the consideration for the sale, except, where the rule applies for determining the consideration for the option, to that extent (in accordance with section 144(2)(a));

(b) the market value rule does not apply for determining the cost to the person exercising the option of acquiring what is sold, except, where the rule applies for determining the cost of acquiring the option, to that extent (in accordance with section 144(3)(a)).

(3) If the option binds the grantor to buy–

(a) the market value rule does not apply for determining the cost of acquisition incurred by the grantor, but without prejudice to its application (in accordance with section 144(2)(b)) where the rule applies for determining the consideration for the option;

(b) the market value rule does not apply for determining the consideration for the disposal of what is bought, but without prejudice to its application (in accordance with section 144(3)(b)) where the rule applies for determining the cost of the option.

(4) To the extent that, by virtue of this section, the market value rule does not apply for determining an amount or value, the amount or value to be taken into account is (subject to section 119A) the exercise price.

(4A) In subsection (4) above "exercise price", in relation to an option, means the amount or value of consideration which, under the terms of the option is—

(a) receivable (if the option binds the grantor to buy), or

(b) payable (if the option binds the grantor to sell),

(c) as a result of the exercise of the option (and does not include the amount or value of any consideration for the acquisition of the option (whether directly from the grantor or not)).

(5) Subsections (5) and (6) of section 144 shall apply for the purposes of this section … as they apply for the purposes of that section."

The decision of the FTT

11. The FTT concluded that the combined effect of s 144ZA(5) and s 144(6) was that the opening words of s 144ZA(2) – "if the option binds the grantor to sell" – must be construed as including a reference to entering into any other transaction which is not a sale. Despite the discretion as to how GS could discharge its obligations under the options on exercise, the FTT reasoned that it remained the case that the options bound GS to enter into a transaction of some sort which would "effectually satisfy Mr Davies's entitlement to the shares which were the subject of the exercised options." We note, in agreement with Ms Black, counsel for Mr

Davies, that in light of the fact that GS could have satisfied the option by paying cash, this sentence ought more accurately to read: "effectually satisfy Mr Davies' rights under the exercised options." The FTT decided that the correct construction of s 144ZA(2) is that it applies to disapply the market value rule in the case of an option binding the grantor to enter into "any other transaction", in the sense of some other transaction, which is not a sale.

The issue on this appeal

12. The sole issue on this appeal is whether the FTT was correct to conclude that s 144ZA applies to the exercise of the options.

13. Ms Black, for Mr Davies, submits that the FTT's interpretation of s 144ZA is wrong both on a literal reading of the provision and on a purposive approach.

14. The essence of her submission is that because GS had a discretion, when the option was exercised, to satisfy Mr Davies' entitlement either by transfer of shares or payment of cash, it was not "bound" to any specific form of transaction, and thus the opening words of s 144ZA(2) – "if the option binds the grantor to sell" were not satisfied. She submits that this is the only permissible reading of the words, such that there is no need to enquire into the provision's purpose. If, which is not accepted, this created an anomaly, then she submits that this falls within the class of case where "the anomaly cannot be avoided by any process of statutory interpretation" (citing *Revenue and Customs Commissioners v Trigg* [2016] UKUT 165 (TCC), at [23]).

15. So far as the literal interpretation of the section is concerned, Ms Black submits that subsection (1), rather than exhaustively defining the scope of the section, is merely a gateway provision and that, in order for the section to apply, the conditions set out in either subsection (2) or (3) must be satisfied (the use of the word "if" at the beginning of each subsection indicating conditionality). She then submits that, in order to give effect to the word "binds" in each of subsection (2) and (3), it is necessary that the option binds the grantor to do one, and only one, thing.

16. It is common ground that, by reason of s 144ZA(5), s 144(6) applies to s 144ZA. Ms Black accordingly accepts that the extended definition of "sell" and "buy" mandated by s 144(6) applies to those words as they appear in s 144ZA(2) and s144ZA(3) respectively, and that those subsections are thus capable of applying in the case of options where the relevant transaction is a sale, or the grant of a lease or any transaction other than a sale. She submits, however, that in order to give proper effect to the word "binds", each subsection applies only where the grantor is bound to enter into one, and only one, specific kind of transaction. Accordingly, if the grantor has a discretion as to the manner in which its obligations under the option are to be exercised, then the option falls outside of both subsection (2) and (3).

17. We cannot accept this argument which, in our judgment, is contrary to the natural reading of the subsections, taken in the context of the section as a whole. The section is at least capable of being read, and in our judgment is most naturally read, as follows:

(1) The circumstances in which s 144ZA applies are set out in subsection (1). They are twofold: (a) an option is exercised, so that by virtue of s 144(2) or (3) the grant or acquisition of the option and the transaction resulting from its exercise are treated as a single transaction, and (b) the market value rule applies, or would apply but for the operation of s 144ZA. It is common ground that both conditions are satisfied in respect of the options in this case.

(2) Subsections (2) and (3) then contain the principal operative provisions of the section. There are two (and only two) circumstances addressed because options fall into one of only two classes: a put, or a call. Subsection (2) addresses the case of a put option, and subsection (3) addresses the case of a call option.

(3) In other words, subsections (2) and (3) do not impose additional conditions for the operation of the section, but merely sub-divide the operation of the section into the two mutually exclusive categories into which all options must fall. The only caveat to this is that a single option transaction may combine elements of put and call. In that case, however, s 144(5) (incorporated into s 144ZA by s 144ZA(5)) treats the transaction as two separate options.

18. Contrary to Ms Black's contention, it is fallacious to suppose that because it is possible to envisage an option that falls outside the scope of subsection (2) and another option that falls outside the scope of subsection (3), there must be a category of option that falls outside both subsections (2) and (3). Where, as here, the two sub-categories cover the entirety of the ground covered by subsection (1), then it is logically permissible to conclude that there is no scope for an option, that falls within subsection (1), falling outside both subsections (2) and (3).

19. This literal reading is supported by the point, forcefully made by Mr Nawbatt QC on behalf of HMRC, with which we agree, that there is no discernible, rational purpose in limiting the effect of s 144ZA to all options other than those where the grantor is permitted a measure of discretion as to how the grantee's entitlement is to be satisfied.

20. HMRC points out that the relevant wording also appears in s 144(2). This provides that if an option is exercised, then its grant and exercise shall be treated as a single transaction, and goes on to explain the consequences of the treatment (a) where the option binds the grantor to sell, and (b) where the option binds the grantor to buy (where "buy" and "sell" have the extended meaning mandated by section 144(6)). Ms Black submits that the phrase "if the option binds the grantor to [sell/buy]" in s 144(2) has the same meaning as that for which she contends in relation to s 144ZA. This would have the effect that s 144(2), while providing in respect of *all* options that the grant/exercise is to be treated as a single transaction, would fail to explain the consequences of that treatment in the case of any option where the grantor had a measure of discretion as to the manner in which the grantee's entitlement is to be satisfied. Again, there is no discernible, rational purpose for such a limitation and, so far as Counsel were aware, it has never been suggested in the fifty or so years since the provision now found in s 144(2) was first enacted.

21. Accordingly, we reject the submission that on a literal interpretation of s 144ZA it does not apply where the grantor has a discretion as to the manner in which the grantee's rights are to be satisfied.

22. So far as a purposive construction of the section is concerned, Ms Black relies on two matters. First, the history of the provision and, second, pre-legislative materials which she submits reveal that the section was intended to apply only to "certain options".

The legislative history

23. It is common ground that s 144ZA was enacted in order to reverse the perceived effect of the decision of the Court of Appeal in *Mansworth v Jelley* [2002] EWCA Civ 1829. Prior to that decision, the position adopted by HMRC was that while the grant and exercise of an option were treated as a single transaction, the cost of acquiring the option was treated as part of the cost of acquiring the subject matter of the option, and the market value rule was not applied to the exercise of the option. Mr Jelley challenged that treatment, on the grounds that it did not give full effect to the requirement to treat the grant and exercise of the option as a single transaction.

24. The Court of Appeal (upholding the conclusion reached by the Special Commissioners, and Lightman J) agreed with Mr Jelley, holding that where the market value rule applied (for example, in the case of employee share options), the deemed acquisition value would be the market value of the underlying asset at the time of the exercise, without taking account of the value of the option itself or the actual cost on exercise.

25. HMRC published guidance on 8 January 2003, in response to that decision, explaining their view as to how gains and losses on the exercise of employee share options should be calculated. Paragraph 3 of that guidance provided as follows:

> "Most of the people affected [by the decision in *Mansworth v Jelley*] will be employees who have sold shares they acquired by exercising unapproved employee share options or Enterprise Management Incentive share options. The CGT acquisition cost of these shares is their market value at the time the option is exercised plus any amount charged to income tax on the exercise.
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> The decision does not affect employees who acquired shares through approved Save As You Earn (SAYE) schemes and approved Company Share Option Plans (CSOPs). Their acquisition cost stays what it was before the *Mansworth v Jelley* decision: the exercise price paid for the shares."

26. This guidance was subsequently re-iterated in March 2003 and again in August 2003. In 2009, however, HMRC recognised that it had made an error in that guidance, the error lying in the addition of the amount charged to income tax to the market value of the subject matter of the option. The 2003 guidance had failed to recognise that if the market value rule applied, it did so in replacement of the actual cost incurred on acquisition and exercise.

27. Ms Black submits that it is important, when interpreting s 144ZA, to appreciate that it was "born out of the decision in *Mansworth v Jelley* and HMRC's mistaken understanding of how amounts liable to income tax should be incorporated into

the CGT computation." She criticises the FTT for having dismissed the legislative history as merely "interesting background".

28. We agree (in common with both parties) that it is appropriate to have regard to the mischief at which s 144ZA was directed. Even taking into account HMRC's mistaken interpretation of the consequences of the decision in *Mansworth v Jelley*, however, and assuming that HMRC's error was shared by the legislature when enacting the provision, this merely confirms that the legislative purpose of the provision was the reversal of the Court of Appeal's decision to apply the market value rule in the case of options generally of the kind at issue in that case. Even if this purpose was informed by HMRC's error, it does not alter the fact that it was indeed the legislature's purpose. The critical point is that nothing in the legislative history relied on by Ms Black suggests, let alone requires, the conclusion that s 144ZA was intended to apply to options otherwise than where the grantor had a discretion as to the manner in which the grantee's rights were to be satisfied.

Pre-legislative materials

29. Ms Black nevertheless submits that the limitation of s 144ZA to options where the grantor does *not* have any discretion as to the manner of exercise is supported by pre-legislative materials. She relies in this regard on the explanatory notes to clause 157 of the Finance Bill 2003 (providing for the insertion of s 144ZA into the TCGA), paragraph 1 of which states that the clause revises provisions in the TCGA relating to the computation of gains and losses "in certain circumstances". The phrase "in certain circumstances" is repeated in paragraph 3, describing the purpose of s 144ZA. Reliance is also placed on the distinction between the description of subsection (1) (in paragraph 8), that it "provides for the section to apply…" and the description of subsection (2) (in paragraph 9), that it "applies to options…" Ms Black also refers to a Budget Note issued by HMRC (REV BN 31) which, in paragraph 3, contains a general description of the measure stating that it affects employees who acquire shares by exercising "certain" employee share options. She submits that these references indicate that the legislature intended that s 144ZA would not apply to all options that fell within subsection (1), and that this supports the contention that subsections (2) and (3) applied only to options where the grantor was bound to enter into one type of transaction only.

30. We reject this submission. There is no indication in any of these materials that the reference to "certain" options was intended to exclude only those options where the grantor had a discretion as to the manner of its exercise. In our judgment each of the references to "certain options" is readily explained by the fact that the purpose of s 144ZA was to reverse the effect of *Mansworth v Jelley* which itself applied only to unapproved option schemes. Approved schemes are dealt with under a wholly separate statutory regime. This point is indeed made expressly in paragraph 6 of the HMRC Budget Note, which identifies unapproved employee share options as the intended target of the new provision.

31. Accordingly, the FTT was correct to conclude that s 144ZA does not exclude from its application options where the grantor has a discretion as to the manner of its exercise.

Disposition

32. For the above reasons we dismiss this appeal.

The Hon Mr Justice Zacaroli

Upper Tribunal Judge Berner

Release date: 30 April 2018