CH 1998 C 746

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

(REVENUE LIST)

B E F O R E: **THE HONOURABLE MR JUSTICE LIGHTMAN**

B E T W E E N:

PAUL ALEXANDER CLARK
(HMIT)

Appellant

-and-

THE TRUSTEES OF THE BRITISH TELECOM PENSION SCHEME
AND OTHERS

Respondents

JUDGMENT

The Solicitor General Lord Falconer of Thoroton QC and Mr Timothy Brennan, instructed by the Solicitor of Inland Revenue for the Appellant

Mr Michael Flesch QC and Mrs Felicity Cullen, instructed by Maxwell Batley for the Respondents

Hearing: 21-23 July 1998

Judgment: 14 October 1998

Lightman J.

1. **INTRODUCTION**

I have before me an appeal by the Commissioners of Inland Revenue ("the Revenue") against a decision ("the Decision") of the Special Commissioners ("the Commissioners") dated the 16th December 1997. The Commissioners allowed the appeal of the Trustees of British Telecom Pension Scheme ("BTPS"), POSSS Custodian Trustee Limited as Administrator of the Post Office Staff Superannuation Scheme ("POSSS") and POPS Custodian Trustee Limited as Trustee of the Post Office Pension Scheme ("POPS") against estimated assessments to income tax for a total sum of some £13 million plus default interest. (I shall refer to the respondents together as "the Trustees" and the three schemes, which are all exempt approved schemes, as "the Schemes"). The assessments arise (in the case of BTPS) in respect of the years 1983/4 to 1994/5 inclusive and total £6,489,250 plus default interest; (in the case of POSSS) in respect of the years 1989/90 and 1990/1 and total £210,000 plus default interest; and (in the case of POPS) in respect of the years 1981/2 to 1994/5 inclusive and total £6,534,250 plus default interest. All the assessments are in respect of sub-underwriting commissions received by the Trustees. The issues raised are whether sub-underwriting commissions received by the Trustees are chargeable to tax under Case I of Schedule D and whether they are also liable to the additional rate of tax applicable to trusts. The Revenue appeals against the Decision to this Court.

2. The Trustees hold very substantial shareholdings. BTPS is the largest single private sector pension scheme in the United Kingdom with assets (as at 31st December 1993) amounting to £17,196 million and in 1996 had a total of 371,060 members. POSSS is half the size of BTPS but is also one of the largest such schemes with a total (in 1996) of 280,667 members. POPS is considerably smaller but has a total of 107,203 members. The Trustees have powers of investment and power to underwrite issues of shares: they have no express power to trade. Their principal activity has been investment, but they have also entered into sub-underwriting agreements under which they have received in the relevant years of assessment underwriting commissions. The Trustees are entitled under Section 592(3) of the Income and Corporation Taxes Act 1988 ("the Taxes Act") to exemption from income tax in respect of such commission if (as the Trustees contend to be the case) the commissions fall within Case VI of Schedule D. The Revenue contend that they do not fall within Case VI, but fall within Case I as receipts of a trade carried on by the Trustees. Whether they are receipts of a trade carried on by the Trustees is the first (and principal) issue before me. The second issue (which only arises if the first question is decided in favour of the Revenue) is whether the commissions, which would otherwise be liable to the additional rate of tax applicable to trusts under Section 686 of the Taxes Act, are saved from such liability as answering the description of "income from investments, deposits or other property". The Commissioners decided the first issue in favour of the Trustees and (though it did not arise for the Decision) the second issue in favour of the Revenue.

3. **FACTS**

The full facts of this case are set out in the helpful and detailed decision of the Commissioners. It is unnecessary to set them out in full in this judgment.

4. The POSSS Scheme was set up on the 1st October 1969, the BTPS Scheme on the 1st April 1983 and the POPS Scheme on the 1st April 1987. The Trustees have delegated investment management of the bulk of their investments (in the case of BTPS some 84% of the total assets of the scheme) to PosTel (now called Hermes). The basic investment policy adopted in respect of these investments is "index tracking", which involves holding the same percentage ("the Index Weighting Percentage") of shares in each company in the FT Actuaries All-Share Index ("the Index"). Index tracking ensures that performance is roughly in line with that of the market. In the case of POPS however, since the scheme is not big enough to track the Index fully, instead there are held shares in a sample of companies so as to match the risk profile and return of shares in the Index. In order to maintain the Index Weighting Percentage, if a company in the Index raises funds by a rights issue, it is necessary for PosTel to acquire shares; and similarly it needs to do so if a new issue results in a company joining the Index. In addition to the portfolios in respect of which the index tracking policy is applied, PosTel has discretionary management of a small companies portfolio holding shares in some 220 companies with a capitalisation below a figure which is currently £300 million. The Trustees have delegated investment management of a relatively small proportion of their investments (in the case of BTPS some 7% of the total assets of the scheme) to Mercury, which is given a wider discretion than PosTel: the fund is limited however to securities primarily quoted on the London Stock Exchange and predominantly (but not exclusively) equities. The Trustees have further delegated investment management of a further relatively small proportion of their investments (in the case of BTPS the balance of the assets of the scheme) consisting of two overseas portfolios to Schroders.

5. It is agreed that 1992/3 may be taken as broadly representative of all the years of assessment under appeal. The established practice in respect of sub-underwriting at the relevant time is set out in the Decision. Where a company listed on the London Stock Exchange wished to raise additional finance by means of a rights issue or an initial public offering, the company needed to ensure that all the new shares were subscribed if the required capital was to be raised. To achieve this result, the company entered into an agreement with a lead underwriter that the underwriter would take up shares which were not subscribed in return for payment of an underwriting commission (normally 2%). The underwriter would then ordinarily lay off all the risk by inviting various financial institutions, such as insurance companies, pension funds and unit trusts, to enter into sub-underwriting agreements under which they agreed to purchase a proportion of the unsold shares at the issue price. In return for assuming this risk, the sub-underwriters were paid by the lead underwriter (not the issuing company), the payment amounting to some 1¼ of the 2% underwriting commission. In the ordinary case there were no unsold shares which the sub-underwriter needed to purchase: but when the sub-underwriter was required to take up shares, these shares were known as "stick". The sub-underwriter might immediately resell or retain them for any period of time.

6. The investment managers were authorised by the Trustees to sub-underwrite. They did not positively seek opportunities to sub-underwrite, but were known in the market to be willing to do so and were accordingly regularly approached to do so, and this

was almost invariably the case in relation to all shares in the Index. (Save in exceptional cases in relation to small companies), there was no opportunity to negotiate terms. When so approached with offers to sub-underwrite, the investment managers would normally need to make and communicate their decision reasonably quickly. The ordinary practice was that an investment manager would examine the proposition and fill in a routine internal appraisal form with basic details of the issue and the reasons for accepting or declining it (an exercise that would take about 15 minutes). The decision would then be approved by another member of PosTel's staff, and then the offer would be accepted or rejected. The offer and acceptance or rejection would be in respect of all PosTel's portfolios and PosTel would subsequently allocate the sub-underwriting between the portfolios as appropriate. The normal practice was to accept. In the normal case the sub-underwriting opportunity arose in respect of shares in a company in which the Trustees held shares offering a rights issue, and accordingly the investment manager would have to make two decisions in respect of the same company, namely whether to exercise the rights and whether to sub-underwrite. The sub-underwriting provided what the Trustees recognised to be "a useful source of extra income", though the sums were "not very great in scheme terms" (see paragraph 23 of the Decision).

7. Some of the findings of the Commissioners in respect of the Trustees' sub-underwriting not already recited can conveniently be set out verbatim:

> *"...*
>
> *39. In the year from 1 April 1992 to 31 March 1993 there were some 5500 purchases and sales overall by PosTel for BTPS and POSSS. Mrs Kirby [of PosTel] produced details of 68 issues underwritten by BTPS and POSSS where commission was received in that year, of which 16 were also underwritten by POPS. 46 of the issues were by companies in the core portfolios of BTPS and POSSS. 20 were in their small companies portfolios out of which 3 were also in their core portfolios and 5 were in their investment trusts portfolios. 14 of the issues were in the core portfolio of POPS and 2 in its small companies portfolio.*
>
> *40. On our analysis of the 68 issues underwritten by BTPS and POSSS there was no stick in 46 issues, the schemes received stick in 13 cases but made no sales in the following twelve months and in 9 cases stick was received but there were sales of stock within 12 months. In respect of the 13 issues where there was stick but no sales, in three cases rights were allowed to lapse, but in each case the stick received exceeded the rights so that the percentage holding increased and in three cases the rights were taken up so that again the percentage holding increased. In four cases the portfolio's percentage holding increased with placings accepted. One case was a new issue with a placing accepted; in one a take-over was accepted and in another conversion terms were accepted. The stick varied from 0.1% to 99%, being over 90% in three cases and under one-half in six cases.*
>
> *46. During the year to 31 March 1993 PosTel declined underwriting offered in five cases. Two were for convertible cumulative redeemable preference shares of which the core portfolio was not a natural holder because they were not in the Index. Two were by companies not in the Index. The other was by a company whose management PosTel did not support; previous actions by the company had diluted the schemes' holdings significantly, meetings to explain these actions had been cancelled by the company and PosTel regarded the directors' remuneration as excessive. Mrs Kirby stated that apart from such exceptional cases, management would be given the benefit of the doubt and supported when raising funds.*

48. The policy of PosTel in accordance with the trustees' directions was to support the management of companies in which the schemes held investments unless there was a contrary reason. Since the schemes were substantial investors and substantial potential sub-underwriters their support was important to companies. If PosTel declined underwriting this would frequently become known in the market with consequent results: it would give a message that PosTel had lost confidence in the management. This was a relevant factor in PosTel's general policy of accepting underwriting.

49. In relation to new issues the position would vary. Sometimes only part of the share capital would be offered to the public; in such cases if the company entered the Index the schemes would require a higher proportion of the public issue in order to achieve the Index weighting. The holding offered on a placing might be insufficient and it might not be easy to build up the holding by purchases in the market. Acceptance of sub-underwriting would give another avenue. Sometimes the offer of sub-underwriting would be combined with an offer on placing so that one would not be available without the other. Brokers were influenced in offering shares on placing by past support by underwriting.

50. One of the most common circumstances in which underwriting was offered was rights issues. The offer would generally be open to share holders for 3 weeks, ... The acceptance of sub-underwriting would have been several weeks earlier. There was thus a period of several weeks during which the price of the quoted shares might rise or fall. The decision whether to accept the rights (or placing) would be deferred until close to the date for acceptance.

52. PosTel had no separate staff or department for dealing with sub-underwriting acceptance, administration or recording. Sub-underwriting was handled by fund managers as part of their general fund management activity.

53. Commission from sub-underwriting was accounted for in the same way as all cash receipts. It was posted in a separate account in the accounting records and included in investment income in the statutory accounts of each scheme. No analysis was made at any time of the profitability or otherwise of the schemes' participation in underwriting; any analysis would have involved an attribution of staff costs to underwriting and consideration of how stock acquired as stick should be treated, in particular whether it should be valued as at the date of acquisition.

54. In the year to 31 March 1993 gross underwriting commission received by BTPS was £809,000, which represented 0.1239% of total investment income of £653 million per the accounts. In the seven years to March 1994, the highest commission percentage was 0.3403% in the year to March 1990 and the lowest 0.1016% in the year to March 1988. Since investment income from UK equities accounted for around half of total investment income, the underwriting commission expressed as a percentage of investment income from UK equities would be about double those percentages. Since nearly all underwriting offered was accepted, it follows that the variation between years reflected differences in underwriting offered from year to year.

55. In the small companies portfolios the schemes typically had quite large stakes in the companies in which they were investors, sometimes as high as 10%. With smaller companies PosTel was often consulted on the terms of the issue before they were finalised. Apart from that the approach of PosTel was similar to that for larger companies. It would have been surprising if PosTel had a major stake in such a company but did not support a rights issue by underwriting when asked since this would show lack of confidence in the management. Normally PosTel was offered underwriting in line with its existing stake but it might be offered more if it was known to be building up a larger holding. In practice 15-20% of an issue was the most that PosTel was offered or accepted.

57. We now come to the evidence of Mrs Kirby and Mr Ross Goobey as to the reasons for sub-underwriting. We attach more importance to Mrs Kirby's evidence because she had been with PosTel since 1985, whereas Mr Ross Goobey only joined in January 1993 towards the end of the sample period. More important, Mrs Kirby was personally involved in the sub-underwriting decisions whereas Mr Goobey was not. Since they were treated as routine, we assume that Mr Goobey was not involved in the decisions in individual cases except possibly in the comparatively rare marginal cases. However as chief executive he presumably had some oversight and was concerned with policy.

58. Mrs Kirby told us that she had no direct knowledge of any policy laid down by the trustees. Since the dispute with the Revenue had arisen she had been involved in discussions with investment management colleagues. In her statement she gave four reasons for accepting underwriting. The first was to support the issuing company, the schemes being shareholders. The second was that PosTel regarded underwriting as a way of reducing the cost to the schemes of shares which they were acquiring in any event. The third was that the schemes needed their share of new issues to maintain the Index weighting and underwriting ensured that they would be favoured in share allocations on new issues. Finally, the underwriting system was part of the capital raising process and to protect the value of its investments the process was facilitated by accepting underwriting. She stated that sub-underwriting was viewed as an integral part of the investment strategy and that shares acquired as underwriting stick were treated exactly as those acquired through other means. She stated that with the exception of very small allocations, which would normally be sold, shares acquired through underwriting would only be sold subsequently either because the managers decided to reduce the overall holding when sales would typically be much greater than any stock or because the holding became excessive in terms of Index weighting. On 1 January 1993 the increase in the Index involved a reduction in the size of all existing holdings to maintain Index weighting; also on the same date the merger of the new and old schemes necessitated sales.

59. Mrs Kirby stated that underwriting was not seen as a means of making money. Underwriting was a cost of raising capital which was ultimately borne by shareholders. PosTel did not wish to see underwriting commission disappear into the pockets of others underwriting purely for commission; if PosTel accepted underwriting equivalent to its holding it did not bear the underwriting cost. Underwriting was a way of reducing the cost of shares which the schemes would acquire in any event.

60. Cross-examined by Mr Brennan, Mrs Kirby said that sub-underwriting was a way of clawing back some of the issuing company's cost of raising capital. It was not a way of making money, there was still a diminution in the value of the existing investment in the company. Another way of looking at it was to reduce the cost of taking up shareholdings. We were impressed by Mrs Kirby as a witness. We found her evidence to be lucid and logical. We accept it as a correct statement of the reasons and motives of the person immediately responsible for the underwriting decisions in respect of the core portfolios.

61. Mr Ross Goobey said that PosTel entered into underwriting commitments only on the basis that it was prepared to retain the shares in the schemes if there was stick. He said that although underwriting was almost invariably accepted, PosTel always made a judgment because of its fiduciary duty. He gave the same reasons for underwriting as Mrs Kirby (see paragraph 58), stressing the confidence factor, BTPS being the largest pension fund. He said that it was reasonable for the trustees to expect PosTel to maintain the wealth which the holdings represented; PosTel had not dictated the underwriting structure and would prefer deeper discounts without the need for underwriting; if it did not underwrite there would be a cost to the schemes. He did not accept that sub-underwriting was an opportunity to make money or that it was simply a source of additional income. He said that it was difficult to tell if

underwriting was generally profitable; there had been no separate analysis of PosTel's underwriting. He agreed that generally issues were priced to succeed rather than fail. In his statement he said that at the time of underwriting, PosTel was indifferent as to whether shares were acquired through underwriting or by taking up rights.

62. Although for the most part we accept Mr Ross Gooney's evidence we find the last statement illogical since there would almost always be an initial paper loss if shares were acquired as stick. If the implication is that underwriting would be accepted even if stick was anticipated at the outset, we do not accept this apart from special situations. If stick was generally expected at the outset, it seems to us that the broker would never obtain the necessary underwriting. It seems to us that it must have been an underlying assumption of PosTel's policy as to underwriting that on the whole it was profitable before taking account of the cost to the issuing company. If this were not so it seems to us that PosTel could not properly have pursued the policy without the express sanction of the trustees. The argument that without underwriting value would have passed out of the schemes' existing holdings, which has logic, has the corollary that there was value in underwriting viewed per se.

63. We now turn to the sub-underwriting in the portfolios managed by Mercury where there were important differences since the portfolios were discretionary and there was no general policy to accept underwriting offered.

64. During 1992/93 Mercury undertook 8 underwriting transactions for the three schemes. The only issue on which it took stick was TI Group which was also underwritten by PosTel. Mercury did not hold TI for the schemes. The issue was to fund the cash alternative for Dowty which was held in the Mercury portfolios. Mercury thought Dowty had potential but should be part of a bigger group and were delighted at TI's offer which it considered generous. Mercury decided to underwrite the offer to support the bid. Some stick was expected (in fact 17% was received) but there was a considerable profit on the Dowty holding. After the issue Mercury held 1,823,241 shares in TI. Nine months later 833,241 were sold, this being an investment decision. No stick was received in any of the other issues underwritten in 1992/93. In the year 1992/93 underwriting commission received was £118,973, 0.275% of total investment income of £43,322.614 on the BTPS funds managed by Mercury; the percentage for POSSS was 0.237%, apparently POSSS did not underwrite one of the issues; POPS underwrote two issues only and underwriting commission was 0.837% of investment income.

65. Mr Charlton told us that Mercury would only accept sub-underwriting on behalf of the Appellants if it was happy to take up the shares sub-underwritten at the sub-underwriting price. He saw the decision to sub-underwrite as an investment decision to take stock at the price offered. Mercury had no general policy to accept sub-underwriting and the decision would depend on the terms of the individual deal; Mercury would consider whether the sub-underwriting price was a good price for that stock and whether the stock was one which Mercury liked. When sub-underwriting was accepted rights were usually taken up unless it looked as if Mercury would be left with stick but, as sub-underwriting was only undertaken when Mercury thought that the price was a good price for that stock, stick was unusual. Stock received as stick was not normally sold unless it was uneconomically small. Mercury never accepted sub-underwriting just for the sake of commission, the amount of which Mr Charlton regarded as de minimis. Mercury managed funds in excess of £3bn for the Appellants and the measurement of their performance was calculated to two decimal places; he said that the level of underwriting commission 'would not register as a flicker on the performance scale'. He said that Mercury would not accept underwriting if it was possible to get a similar amount of shares cheaper; sometimes however shares could be bought more cheaply but not the amount Mercury wanted. He said that increasingly Mercury would be consulted a day earlier than the sub-underwriting offer and would have some input on the issue

price and thus the discount. Sometimes an issue would be aborted because of Mercury's objections.

8. **STATUTORY PROVISIONS**

The first and principal issue before me relates to Section 592 of the Taxes Act. Part XIV of the Taxes Act contains provisions relating to pension schemes. Section 592 gives exemption from income tax to certain income of exempt approved schemes and the relevant parts of the section provide as follows:

> *"(2) Exemption from income tax shall ... be allowed in respect of income derived from investments or deposits if ... it is income from investments or deposits held for the purposes of the scheme.*
>
> *(3) Exemption from income tax shall ... be allowed in respect of underwriting commissions if ... the underwriting commissions are applied for the purposes of the schemes and would, but for this subsection, be chargeable to tax under Case VI of Schedule D."*

(Before 1988 similar provisions were contained in section 21(2) and (2A) of the Finance Act 1970 as amended by the Finance Act 1971.)

Section 18 of the Taxes Act provides that tax under Schedule D shall be charged under the six cases set out in subsection (3). The relevant cases are Case I and Case VI. Case I reads:

> *"tax in respect of any trade carried on in the United Kingdom ...".*

Case VI (which is the residuary case), reads:

> *"tax in respect of any annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A, [B], C or E".*

It is therefore immediately apparent that if, as the Revenue contends, the activity of sub-underwriting for reward as carried on by the Trustees amounts to a trade taxable under Schedule D Case I, that activity does not fall within Case VI and therefore cannot qualify for the exemption. The Commissioners held that the activity did not constitute trading and fell within Case VI. The Revenue contend that, while "trading" is a question of fact, the Commissioners' approach to the question was fundamentally flawed and that their conclusion cannot stand.

9. The second and subsidiary issue, on which the Commissioners found in favour of the Revenue, only arises if I hold (reversing the decision of the Commissioners) that the Trustees carried on the trade of sub-underwriting. This point turns on the construction of section 686(2)(c) of the Taxes Act. Part XV of the Taxes Act relates to settlements and section 686 imposes a liability to additional rate tax on certain income of discretionary trusts. The relevant parts of that section, as originally enacted, provided:

> *"(1) So far as income arising to trustees is income to which this section applies it shall, in addition to being chargeable to income tax at the basic rate, be chargeable at the additional rate.*

> *(2) This section applies to income arising to trustees in any year of assessment so far as it - ...*
>
> *(c) is not income ... from investments, deposits or other property held for the purposes of a fund or scheme established for the sole purpose of providing relevant benefits within the meaning of section 612."*

(Before 1988 similar provisions were found in section 16(2)(c) of the Finance Act 1973). A new paragraph (c) to subsection (2) was substituted by the Finance Act 1988 with effect from 1 July 1988:

> *"(c) is not income ... from investments, deposits or other property held -*
>
> *(i) for the purposes of a fund or scheme established for the sole purpose of providing relevant benefits within the meaning of section 612;*
>
> *..."*

The Finance Act 1993 made further amendments with effect from 1993/94, substituting a new subsection (1) and new subsections (1A) and (2A); those amendments are not material to this appeal. In short Section 682(2)(c) exempts from payment of an additional rate of tax where the income is from "investments, deposits or other property". The issue is whether the trade of sub-underwriting, or the sub-underwriting contracts entered into in the course of such trade, constitute "property" within the meaning of the section and accordingly the income arising therefrom falls within the exemption.

10. **FIRST ISSUE - WHETHER TRUSTEES WERE TRADING**
LEGAL BASIS FOR CHALLENGE TO DECISION

It is common ground that the decision of the Commissioners can only be disturbed if they can be shown to have committed an error of law which vitiates their decision or if their decision is one which no reasonable decision-maker on the finding of facts which the Commissioners made could have reached. The relevant principles are stated by Nourse J in *Cooper v. C & J Clark* Ltd 54 TC 670 at 676-7. In that case a shoe manufacturer, having a cash surplus, over a nine month period entered into thirteen transactions involving the purchase and sale of gilt-edged securities. These resulted in a substantial loss. The issue was whether the loss was a trading loss arising from the conduct of a separate trade of dealing in securities or was a loss arising from investments made as a speculator on the Stock Exchange. The Commissioners held that the loss was a trading loss. The Revenue appealed. Nourse J. said as follows:

> *"It has been settled law ever since the decision of the House of Lords in Edwards v. Bairstow 36 TC 207 that in order to succeed on an appeal of this kind the Crown must show, first, that on the material facts the true view is that the loss of £96,587 arose from a temporary investment of moneys surplus to current requirements not amounting to a separate trade of dealing in securities; and, secondly, that that was the only conclusion to which the Commissioners could reasonably have come. It is perhaps more common to express that twofold test as one, but I find the division helpful as reflecting the two stages in which these cases are invariably argued and sometimes decided.*

...

> *If my function was simply to decide this case on the facts as they appear to me, I very much doubt whether I would think that the true view was that the loss of £96,587 arose from a separate trade of dealing in securities. It would seem to me that the purchases and sales in question were relatively, indeed markedly, insignificant in relation to Clarks' other activities. There were at the most only thirteen of them, and they extended over no more than nine months. I think it very likely that I would conclude that there was merely a temporary course of investment of moneys surplus to current requirements not amounting to such a trade. However, that is not my function and I must now consider whether the latter view represents the only conclusion to which the Commissioners could reasonably have come.*
>
> *The question whether a given state of affairs does or does not amount to a trade is one of fact and degree. Sometimes it is clear, as it was to Pennycuick J in Lewis Emanuel & Son, Ltd v. White 42 TC 369, that there was a trade. At other times it is clear, as it was to the House of Lords in Ransom v. Higgs [1974] 1 WLR 1594, that there was not. In those cases the Court can and must interfere with the Commissioners' decision. But often, as Lord Simon of Glaisdale well put it in Ransom v. Higgs at page 1619D, between the two extremes there lies a 'non-man's land' of fact and degree where it is for the Commissioners to evaluate whether the activity amounts to a trade or not. The Court can only interfere where the degree of fact is so inclined towards one frontier or the other as to lead it to believe that there is only one conclusion to which the Commissioners could reasonably have come.*

The Revenue contends that the Commissioners' decision is vitiated by four specific errors of laws and that their decision is one which they could not reasonably reach.

11. **COMMON GROUND**

(a) Law

It was common ground before the Commissioners, as it was common ground before me, that (depending upon the facts of the particular case) as a matter of law the activity of sub-underwriting (whether carried on by the Trustees or anyone else) may or may not constitute the carrying on of a trade and will (if it does) fall within Case I and will (if it does not) fall within Case VI. It was likewise common ground that guidance is provided as to the meaning of the word "trade" (and accordingly whether upon the facts of this case the Trustees traded) by the speeches of Lord Reid and Lord Wilberforce in *Ransom v. Higgs* 50 TC 1. Lord Reid said at p.78:

> *"As an ordinary word in the English language "trade" has or has had a variety of meanings or shades of meaning. Leaving aside obsolete or rare usage, it is sometimes used to denote any mercantile operation, but it is commonly used to denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or service."*

Lord Wilberforce said at p.88:

> *"Trade cannot be precisely defined, but certain characteristics can be identified which trade normally has ... Sometimes the question whether an activity is to be found to be a trade becomes a matter of degree, of frequency, of organisation, even of intention, and in such cases it is for the fact-finding body to decide on the evidence whether a line is passed ... Trade involves, normally, the exchange of goods or of services for reward ... there must be something which the trader offers to provide by way of business."*

Further reference was made to the passage in the judgment of Jenkins LJ in *Davies v. The Shell Company of China Ltd* 32 TC 133 at pp.155-6:

> *"... the mere fact that a certain type of operation is done in the ordinary course of a company's business and is frequently repeated, does not show that the transactions in question is a trading transaction; you have to look at the transaction and see what its nature was ..."*

(b) Fact

It was also common ground before the Commissioners, as it was common ground before me, that as a matter of fact the entry by the Trustees into sub-underwriting agreements over the years covered by the assessments was "habitual, organised, for reward, extensive and business-like" (see e.g. paragraphs 86, 88 and 103 of the Decision); that it was assumed to be a profitable activity and (as is obvious and as the Commissioners found as a fact) the Trustees would not have carried it on if it was not (see paragraph 62 of the Decision).

(c) Issue

It was likewise common ground that for the purpose of this appeal no distinction was to be drawn between the Schemes: it was not suggested that the facts are such that the liability to tax is different in respect of any one of the Schemes from the others.

(d) Consequence of Error

It was common ground that, if I found that the Commissioners had made an error which vitiated their decision, it was open to me in my discretion either to remit the matter to the Commissioners to reconsider their decision in the light of my judgment or to decide the two issues raised in this case myself.

12. **THE ALLEGED ERRORS**

I shall now turn to consider whether the Decision is vitiated by an error of law as the Revenue contends. The alleged errors are: (a) concentration on Case VI instead of Case I; (b) the "purposive construction" applied to Section 592(3) of the Taxes Act; (c) the relationship of the Trustees' sub-underwriting and investment activities; and (d) the weight given to the Trustees' motives for carrying on the sub-underwriting activity.

13. **CONCENTRATION ON CASE VI**

The first contention made is that the Commissioners set about their task by asking themselves what was the true ambit of Case VI, and whether the activity of the Trustees was capable amounting to something less than the carrying on of a trade and accordingly of falling within Case VI (see paragraphs 77-81 of the Decision), when their starting point should have been whether the activity fell within Case I. I agree with the Revenue that the Commissioners can and should have concentrated on the ambit of Case I, and it is unsettling to find the Commissioners adopting the starting point which they did. But it is clear that the Commissioners, after considering the ambit of Case VI, went on to consider the ambit of Case I, and I do not think that the

choice of starting point necessarily involves any error in the conclusion ultimately reached. Accordingly I reject this contention.

14. **PURPOSIVE CONSTRUCTION OF SECTION 592(3)**

The second contention of the Revenue is far more substantial. It is to the effect that the basis for the decision of the Commissioners was that commissions, which (if earned by others) would constitute the profits of the trade of sub-underwriting and fall to be chargeable to tax under Case I, may not constitute the profits of a trade and fall to be so chargeable if earned by trustees of an exempt scheme; and that is because a "purposive" construction must be applied to Section 592(3) of the Taxes Act. The argument to this effect addressed to the Commissioners by Mr Flesch on behalf of the Trustees is recorded in paragraph 70 of the Decision:

> *"70. Thirdly, Mr Flesch argued that the exemption in Section 592(3) had to be construed in a meaningful way and could not have been intended to apply only to casual and isolated transactions; the subsection related only to exempt approved schemes and had to be considered within that context. He cited Inland Revenue Commissioners v. McGuckian [1997] STC 908 as authority for the view that, in interpreting taxing statutes, the context and scheme of the relevant Act as a whole and its purpose should be regarded. The purpose of Section 592(3) was to exempt the investment activities of pensions funds the trustees of which did not normally engage in trade ..."*

15. In my view, it is clear from a reading of the Decision as a whole that this argument was accepted. For example, after stating in paragraph 85 that the sub-underwriting in this case in return for a commission viewed in the abstract has features indicative of a trade, the Commissioners in paragraphs 86 and 87 went on to say as follows:

> *"86. We are however not considering an abstract situation, but actual transactions in respect of exempt approved schemes for which Parliament has made specific provision in Section 592(3). If the very nature of sub-underwriting meant that it was trading Section 592(3) would be devoid of meaning. The Taxes Act is a consolidated Act which must be construed as a whole ... The logic is therefore that underwriting by exempt approved schemes is not necessarily trading. Mr Brennan accepted this but said that it was trading unless carried out on isolated occasions and not on a habitual, organised, extensive or business-like basis. The difficulty with this approach is that pension fund trustees and their managers are under a duty to be organised and business-like and that sub-underwriting will not be offered unless they are likely to accept it. This approach, therefore, whilst paying lipservice to the efficacy of Section 592(3), in effect negates it.*
>
> *87. It seems to us that in relation to exempt approved schemes the mere fact that the transactions consist of underwriting must in view of Section 592(3) be neutral. For the subsection to have any real significance there must be a broad spectrum of fact situations where underwriting for exempt approved schemes is within Case VI; on the other hand it is specifically contemplated that not all underwriting commissions are chargeable under Case VI."*

16. This view of the special ambit of Case VI in case of exempt schemes formed a critical part of its decision-making. It is sufficient to refer to two further paragraphs of the Decision:

> *"92. We consider that, giving proper weight to the scheme of the Act including Section 592(3), the subject matter of the transactions, their frequency, length and the*

> *fact that they were habitual and organised do not determine whether they are trading. These are all features which are characteristic of sub-underwriting in respect of exempt-approved schemes ...*
>
> *103. In relation to the core Index-tracking funds we find that the sub-underwriting did not constitute a trade. Bearing in mind the provisions of Section 592(3) we consider that the subject matter, frequency, organisation and extent of the transactions were not determinative ..."*

17. Mr Flesch in his skeleton argument on this appeal put forward the same submission as had found favour with the Commissioners. Paragraph 13 reads as follows:

> *"13. Section 592(3) should be construed purposively: see IRC v. McGuckian [1997] STC 908, especially at pp 915 c - 916 h and at p 920 e-h. It cannot have been Parliament's intention to restrict relief to cases where Pension Funds only undertook very occasional underwriting. For large Pension Funds the relief would become meaningless."*

When I made clear to Mr Flesch my lack of enthusiasm for this submission, he did not press it. The submission was in my view plainly incorrect and Mr Flesch wisely did not (as he could not) seriously seek to defend it. Section 592 requires determination of the question whether the income from an activity of the Trustees constitutes the profits of a trade falling within Case I. The criterion as to what does or does not constitute "profits of a trade" is the same in all cases where this question arises. There is no predisposition in favour of holding that the profits earned by the trustees of exempt schemes do not fall within Case I; and there is no special meaning to be given to the word "trade" where the activity in question has been carried on by trustees of exempt schemes. The premise on which Section 592 is based is that, depending on all the circumstances, receipt of profits from sub-underwriting by trustees of exempt schemes (as by anyone else) may fall within Case I or Case VI. The same test is to be applies in case of trustees of exempt schemes as in case of anyone else. The fact that the answer to that question decides whether there is entitlement to an exemption under Section 572(3) is irrelevant in deciding what the answer is.

18. I accordingly hold that the Commissioners made a critical mistake as to the legal test to be applied in deciding whether the Trustees' receipt of commissions under their sub-underwriting contracts constituted receipts of a trade and that this error vitiated their decision. In these circumstances, I have to decide whether I should determine the issue whether the Trustees traded or to refer it back to the Commissioners. Neither side has argued in favour of my referring the issue back to the Commissioners or suggested that there is any reason for, or advantage in, referring it back. To do so would occasion unnecessary delay and cost and I have the full material before me to enable me to make the decision myself. Accordingly I shall decide this question myself. My finding of this error on the part of the Commissioners dispenses with the need to decide whether any other vitiating error was made by the Commissioners. It is I think appropriate to proceed with my own determination of the trading issue and in the course of that determination consider the relationship of the Trustees' sub-underwriting and investment activities and the weight to be given to their motives.

19. **DETERMINATION OF ISSUE OF TRADING**

The approach which commends itself to me, as it apparently commended itself to the Commissioners, to the issue whether the Trustees have traded is two stage. The first stage is to concentrate on the relevant activity of the Trustees in entering into sub-underwriting contracts and consider whether, viewed objectively, that activity bears the legal character of a trade. If viewed objectively the activity clearly and unequivocally bears the legal character of a trade, that is the end of the matter. If however viewed objectively the legal character of the activity is equivocal, it is appropriate to proceed to a second stage. At this second stage it is appropriate to consider how far further light is cast on the activity and how far its legal character is affected by the particular facts of this case or, as it might be expressed, the particular context in which the activity is carried on and most particularly, the relationship of this activity with the Trustees' investment activity and the Trustees' purpose or motive in carrying on the sub-underwriting activity.

20. **STAGE 1**

I accordingly as the first stage concentrate my attention on the sub-underwriting activity of the Trustees and in this context on the common ground as to law and fact to which I referred in paragraph 11 above. In my judgment the activity (in the language of Lord Reid) involved operations of a commercial character by which the Trustees provided to customers (namely the lead underwriters) for reward a service, namely sub-underwriting; and (in the language of Lord Wilberforce) involved over a period of years the exchange of services for reward and was frequent (or habitual) and organised as well as extensive, business-like and for profit. In short, viewed objectively the activity has all the hallmarks of a trade; and since the activity unequivocally constitutes a trade, there is accordingly no occasion to proceed to the second stage.

21. The Commissioners took a contrary view and it is accordingly appropriate to examine their reasoning. Paragraph 84 of the Decision reads as follows:

> *"Sub-underwriting is clearly an operation by which a service is provided for reward; it is less clear whether it constitutes 'operations of a commercial character' in the sense envisaged by Lord Reid or whether the companies making issues are 'customers'. Nor is it clear whether the schemes 'offer' sub-underwriting in the sense envisaged by Lord Wilberforce."*

Mr Flesch was unable to explain, and I cannot understand, why sub-underwriting did not clearly constitute "operations of a commercial character" as envisaged by Lord Reid or why the Trustees did not "offer" sub-underwriting in the sense envisaged by Lord Reid. (The Commissioners appear to have been troubled by the fact that the Trustees did not actively solicit sub-underwriting, but this is not significant: they did not need to. As they well knew, it was sufficient in order to obtain trade that they allowed it to be known that they would accept offers of sub-underwriting: see paragraph 88). Further it is clear (as Mr Flesch conceded) that the Trustees offered services to customers (namely the lead underwriters). The Commissioners are correct that services were not offered to the companies making issues and they were not customers, but that is irrelevant.

22. The Commissioners went on in paragraphs 85 and 86 to say :

> *"85. ..Viewed in the abstract sub-underwriting has features indicative of a trade. Its essence is the acceptance of a risk for reward...*
>
> *86. We are however not considering an abstract situation but actual transactions in respect of exempt approved schemes for which Parliament has made specific provision in Section 592(3).*
>
> *87. It seems to us that in relation to exempt approved schemes the mere fact that the transactions consist of underwriting must in view of Section 592(3) be neutral.*
>
> *88. Mr Brennan relied on the fact that the sub-underwriting activities were habitual, organised, for reward extensive and business-like. Any underwriting will be for reward: a trustee underwriting gratuitously would almost certainly be in breach of trust. It was the duty of the scheme trustees to be organised and to act in a business-like way; the fact that they acted in an organised and business-like way seems to us to be of little if any assistance."*

Notwithstanding the reservations expressed in paragraph 84 (for which there was no justification) the Commissioners were impelled in paragraph 85 to accept that "viewed in the abstract sub-underwriting has features indicative of a trade". The Commissioners then in paragraphs 86-88 discounted these features because they considered that they were required by Section 592(3) to do so in cases where the sub-underwriting was by trustees of an exempt scheme. Section 592(3) did not so require them. With those reservations and discounts removed (as they should be), the conclusion can and should be expressed more positively; and the contra-indication relied on by the Trustees (the required purposive construction of Section 592(3)) has no place in the equation.

23. **STAGE 2**

(a) Context

A number of features are relied on by the Trustees to negate the conclusion that the Trustees have traded. The first and primary such feature was the connection between the Trustees' investment activities and sub-underwriting activities and it was contended that the connection was such that the sub-underwriting transactions were undertaken as an essential part of the investment process and were integral to, and ancillary to, and took their colour from the investment process; and that they accordingly could not constitute the conduct of the trade of sub-underwriting.

24. The authorities cited to the Commissioners and to me establish that an activity may be so closely linked to another activity that on a proper analysis it is an integral part of that activity and not a separate trade. Thus in *Imperial Tobacco Co (of Great Britain and Ireland), Ltd v. Kelly* 25 TC 292 a customer bought US dollars in advance solely to pay for tobacco leaf which it purchased from the USA; the purchases of tobacco leaf could not proceed because of the outbreak of war; and the customer thereupon sold the dollars for a profit. The Court of Appeal held that this profit fell within Case I (and was not a profit made on a temporary investment not assessable to income tax) because the purchase of dollars was a trading transaction: it was an essential part (indeed the first step) in carrying out an intended commercial transaction in the course of the customer's trade. Lord Greene MR at p.300 said:

> *"The purchase of the dollars was the first step in carrying out an intended commercial transaction, namely, the purchase of tobacco leaf. The dollars were bought in contemplation of that and nothing else. ... In the light of those facts, the acquisition of these dollars cannot be regarded as colourless. They were an essential part of a contemplated commercial operation."*

By way of contrast in *Davies v. The Shell Company of China Ltd* 32 TC 133, exchange profits made on deposits required and received from some 600 agents on their appointment by the taxpayer were held not to constitute trading profits. The taking of the deposits was not a trading receipt: it was the receipt of a loan.

> Jenkins LJ at p.151 said:
>
> *"...where a British company in the course of its trade engages in a trading transaction such as the purchase of goods abroad, which involves, as a necessary incident of the transaction itself, the purchase of currency of the foreign country concerned, then any profit resulting from an appreciation or loss resulting from a depreciation of the foreign currency embarked in the transaction as compared with sterling will prima facie be a trading profit or a trading loss for Income Tax purposes as an integral part of the trading transaction.*
>
> *...*
>
> *The real issue is whether the taking of each deposit on the terms of the relative deposit agreement was a trading transaction or not."*

He held that the answer was in the negative.

25. Amongst the facts established in this case are the following:

> (1) the Trustees only entered into sub-underwriting contracts in respect of shares in companies in which they wished to invest:
>
> (2) the Trustees' policy was to support the management of companies in which they held investments unless there was a contrary reason; their support as substantial investors and potential underwriters was important to those companies; and to decline underwriting would become known in the market and send a message that the Trustees had lost confidence in the management of those companies. Accordingly the Trustees adopted the general policy of accepting offers of underwriting issues of shares in those companies (see paragraphs 47-48 and 51 of the Decision);
>
> (3) brokers were influenced in offering to the Trustees shares on placing by the past support shown by underwriting (see paragraph 49 of the Decision);
>
> (4) sub-underwriting was viewed as an integral part of the Trustees' investment strategy (para 58 of the Decision) and not as a means of making money, but as reducing the cost of shares which the Schemes would acquire in any event (see paras 59-61 of the Decision);

(5) PosTel had no separate department, staff or premises for dealing with sub-underwriting because none was needed; sub-underwriting was handled by fund managers as part of their general fund management activity (see paragraph 52 of the Decision);

(6) the income from sub-underwriting though valued (relative to the Trustees' investment income) was small. The profits (or losses) from sub-underwriting were not separately calculated, but all receipts were included by the Trustees as part of their investment income;

(7) the sub-underwriting income was received in return for sub-underwriting services from the lead underwriter, unlike the investment income which arose from the ownership of shares or stock and was payable by the company whose shares or stock was held.

26. The Commissioners accepted Mr Flesch's submission that "sub-underwriting in fact formed an integral part of the investment process and took its colour therefrom" (see paragraph 103 of the Decision). I am in some difficulty in understanding and evaluating this holding. The Commissioners appear to be expressing the view taken by the Trustees of the two activities and the way they were carried on. There can be no doubt that: (1) investment and sub-underwriting are separate activities; (2) investment activities can be carried on without sub-underwriting: sub-underwriting is not an essential part of investment; (3) the Trustees' investment activities provided opportunities for profitable sub-underwriting and sub-underwriting in turn gave rise to advantageous investment (i.e. placing) opportunities and was conducive to the well being of companies in which investments were made; (4) the two activities could be and were to great advantage carried on together; and (5) the sub-underwriting on its own was assumed to be profitable and would not otherwise have been undertaken. The undoubted fact is that (jointly with their activity in the field of investment), the Trustees (for good commercial reasons) engaged in the separate and distinct activity of sub-underwriting. This was the commercial reality, which can not be obliterated or obscured by any different perceptions on the part of the Trustees or the way their business activities are managed or the way the receipts are applied or treated in their accounts.

27. **MOTIVE**

The Commissioners gave much weight to the motives of the Trustees in entering into underwriting contracts. The Commissioners took the view that the Trustees' entry into the sub-underwriting contracts might or might not constitute trading and that in view of this ambiguity, the Trustees' intention (or motive) is important (see paragraph 103 of the Decision). They went on to hold that the Trustees did not enter into the sub-underwriting transactions for any independent trading purpose, but as part of their support for issues by companies in which they invested (paragraph 101) and that their motive was not to create a separate profit-centre (see paragraph 103 of the Decision). The Commissioners held that, on the basis that "the sub-underwriting transaction ... could either be trading or not" (paragraph 100) and "the circumstances of the transactions viewed objectively do not indicate trading and at the most are ambiguous" (paragraph 107) the absence of an intention on the part of the Trustees to

trade "demonstrate that the activities were regarded as incidental and ancillary to investment and to the advance of the overall investment objectives" (paragraph 107).

28. The legal principles governing the part played by motive or intention in determining whether there has been trading are stated in the case of *Iswera v. CIR* [1965] 1 WLR 663. The appellant in that case purchased a site on part of which he wanted to build a house to live in; to raise and pay off the purchase price for the site he immediately divided the site into 12 lots and sold off 9 lots. The Revenue assessed the appellant to income tax on the ground that the whole transaction was an adventure in the nature of trade. The Privy Council upheld this assessment. Lord Reid (giving the Opinion of the Board) said as follows:

> *"Before their Lordships, Counsel for the appellant came near to submitting that, if it is a purpose of the taxpayer to acquire something for this own use and enjoyment, that is sufficient to show that the steps which he takes in order to acquire it cannot be an adventure in the nature of a trade. In their Lordships' judgment that is going much too far. If, in order to get what he wants, the taxpayer has to embark on an adventure which has all the characteristics of trading, his purpose or object alone cannot prevail over what he in fact does. But if his acts are equivocal, his purpose or object may be a very material factor when weighing the total effect of all the circumstances."*

29. It only falls to apply those principles to the facts of this case. The Trustees in order to get what they wanted, namely certain investment advantages and an element of extra income, had to embark on the activity of sub-underwriting; that adventure had all the characteristics of trading: there was nothing equivocal about it; accordingly the Trustees in this regard were trading. It is legally irrelevant whether they analysed their activity as trading or whether they regarded or dealt with the income arising from this activity as trading or investment income.

30. **CONCLUSION ON APPEAL**

For the reasons which I have given, I have reached the conclusion that the Trustees in respect of their sub-underwriting activity were trading: that is the conclusion which (in view of the proved error of law in their reasoning) I am free to reach. Indeed I go further and hold that (as the Revenue have submitted) that is the only conclusion which the Commissioners could have reached if properly directed in law. I accordingly allow the Revenue's appeal.

31. **CROSS-APPEAL**

In view of my decision that the Trustees were trading, the issue does arise whether they are liable to the additional rate of tax or are exempt from it on the ground that the income so earned is from "investments deposits or other property" within the meaning of those words as used in section 682(2)(c) of the Taxes Act.

32. The language of section 686(2)(c) is in my view, as in the view of the Commissioners, quite inappropriate to catch or include income arising from the trade of sub-underwriting and from entering into sub-underwriting contracts in the course of such trade. The exemption is limited to income of "investments deposits and other property". Though the word "property" can have a very wide meaning, in this context the word is to be construed *ejusdem generis* with the words it follows, namely

"investments" and "deposits"; it connotes some asset held by the trustees which (like investments and deposits) produces income. The draftsman plainly had in mind assets such as real estate producing rentals or intellectual property rights producing licence fees. The language of the exemption is not designed to include any income of the trustees but only income of the designated character. It restricts the exemption to the fruits of ownership: it does not extend to the fruits of activities, whether trades or businesses, carried on by trustees or the sums payable to them under contracts entered into in the course of such activities. This approach is entirely in accordance with the scheme of section 18 of the Act. For Schedule D draws the same distinction between the annual profits arising "from any kind of property" and arising "from any trade": see and compare Schedule D(1)(a)(i) and (ii) and D(3) Case I and Case V.

33 . I accordingly uphold the decision of the Commissioners that, if (as I have held) the sub-underwriting commissions are chargeable to tax under Case I of Schedule D, the Trustees are also liable to the additional rate of tax applicable to trusts.