THE SPECIAL COMMISSIONERS

THE TRUSTEES OF BRITISH TELECOM PENSION SCHEME

POSSS CUSTODIAN TRUSTEE LIMITED
as administrator of the Post Office Staff Superannuation Scheme

POPS CUSTODIAN TRUSTEE LIMITED
as trustee of the Post Office Pension Scheme

Appellants

- v -

PAUL ALEXANDER CLARKE (HMIT)

Respondent

Special Commissioners: Mr Theodore Wallace and Dr A N Brice

Sitting in private in London on 15, 16, 17 and 18 September 1997

Mr Michael Flesch QC with Mrs Felicity Cullen, Counsel, instructed by Messrs Deloitte &Touche, Chartered Accountants, for the Appellants

Mr Timothy Brennan, Counsel, instructed by the Solicitor of Inland Revenue, for the Respondent

DECISION

1. The Trustees of British Telecom Pension Scheme, POSSS Custodian Trustee Limited as Administrator of the Post Office Staff Superannuation Scheme, and POPS Custodian Trustee Limited as Trustee of the Post Office Pension Scheme (the Appellants) appeal against estimated assessments to income tax. The assessments in respect of the British Telecom Pension Scheme ("BTPS") were for the years 1984/84 to 1994/95 inclusive and totalled £6,489,250 (tax) plus default interest; those in respect of the Post Office Staff Superannuation Scheme ("POSSS") were for the years 1989/90 and 1990/91 and totalled £210,000 (tax) plus default interest; those in respect of the Post Office Pension Scheme ("POPS") were for the years 1981/82 to 1994/95 inclusive and totalled £6,534,250 (tax) plus default interest. All of the assessments were estimated. The appeals were lodged with the Special Commissioners on 7

January 1996 and on 2 May 1997 the Presiding Special Commissioner directed that the appeals of the Appellants be heard together. The assessments were raised because the Inland Revenue were of the view that sub-underwriting commissions received by the Appellants were chargeable to tax under Case I of Schedule D and were also liable to the additional rate of tax applicable to trusts.

The Legislation

2. Part XIV of the Income and Corporation Taxes Act 1988 (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 provide:

> "(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 scheme and would, but for this subsection, be chargeable to tax under Case VI of Schedule D".

The italics here and in paragraphs 4,5 and 6 are ours.

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

4. Section 659A of the Taxes Act which was inserted by the Finance Act 1990 with effect from 26 July 1990 clarifies the meaning of "investments" in section 592(2). The relevant part of section 659A provides:

> "(1) For the purposes of section 592(2) ...
>
> (a) 'Investments' (or 'investment') includes future contracts and options contracts; and
>
> (b) income derived from transactions relating to such contracts shall be regarded as income derived from (or income from) such contracts.
>
> ..."

5. 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".

6. 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;

..."

7. 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.

Outline of issues

8. The Appellants are trustees of exempt approved schemes and were paid sub-underwriting commissions in the relevant years of assessment which commissions were applied for purposes of the schemes. The Appellants claimed exemption from income tax under section 592(3) on the ground that the commissions would be chargeable to tax under Case I. Accordingly, the main issue for determination in the appeal was:

(1) Whether the commissions were chargeable to tax under Case VI of Schedule D, and thus exempt from income tax under s.592(3) or its predecessor, or whether the commissions were receipts of a trade chargeable to tax under Case I of Schedule D and thus not exempt from income tax under section 592(3) or its predecessor.

9. The Appellants put forward two alternative arguments. They argued that, even if the commissions were not exempt under section 592(3), they were, after 26 July 1990,

exempt under section 592(2), as construed in accordance with section 659A, on the ground that the sub-underwriting transactions were options contracts within the meaning of section 659A. Accordingly, the second issue for determination in the appeal was:

> (2) whether the sub-underwriting transactions were options contracts within the meaning of section 659A.

10. The Appellants' second alternative argument was that, even if the commissions were not exempt from income tax, they were not liable to the additional rate of tax applicable to trusts because the commissions were income arising from "other property" within the meaning of section 686(2)(c). Accordingly, the third issue for determination in the appeal was:

> (3) whether the commissions were income arising from "other property" within the meaning of section 686(2)(c).

The evidence

11. At the hearing of the appeal four bundles of documents, which included a Statement of Agreed Facts, were produced by the Appellants and another bundle was produced by the Inland Revenue. Not all the documents were referred to at the hearing. Oral evidence was given on behalf of the Appellants by:

> Mr Alastair Ross Goobey MA; Mr Ross Goobey is a member of the Securities Institute and is the Chief Executive and Chief Investment Officer of Hermes Pension Management ("Hermes"), which is the principal investment manager for the Appellants' schemes; he is also chairman of Hermes Investment Management Ltd; he joined PosTel Investment Management Ltd ("PosTel") on 24 January 1993; on 1 April 1995 Pos Tel changed its name to Hermes Pension Management Ltd; he has been involved with underwriting since 1969;
>
> Mrs Ingrid Alison Kirby BA; Mrs Kirby is a Member of the Securities Institute and has a Diploma of that Institute; she is the Director of International Index Tracking at Hermes; she joined PosTel in 1985 and has been involved with underwriting since that date;
>
> Mr Thomas William George Charlton BA; Mr Charlton is a non-practising Solicitor and a member of the Securities Institute; he is a Director of Mercury Asset Management plc ("Mercury") which manages funds for each of the Appellants; Mr Charlton is currently the UK Equity Manager for the assets which Mercury manages for the Appellants and he has been involved with the Appellants'

schemes since 1986.

12. We accept the evidence of all the witnesses where we have referred to it in our findings of facts, except where we have stated otherwise in this decision.

Application to treat 1992/93 as a sample year

13. At the commencement of the hearing Mr Flesch, on behalf of the Appellants, applied for a direction that, for the purposes of the production of documentary evidence, the year 1992/93 be treated as a sample year and determinative of all of the fourteen years of the assessments; he said that a considerable amount of work had been required to analyse all the sub-underwriting transactions for that one year and that, although the number of transactions varied from year to year, the Appellants had adopted the same investment strategy in all the years. For the Inland Revenue Mr Brennan argued that the burden of proof was on the Appellants to satisfy the Special Commissioners in respect of each separate year; he pointed out that the number of transactions in 1992/93 was half the number in the preceding year and half the number in the succeeding year.

14. We gave no direction at the commencement of the hearing that 1992/93 could be treated as a sample year and determinative of all the years of assessment. We pointed out that it would be a matter of evidence whether 1992/93 was representative. In the event Mr Brennan did not cross-examine the Appellants' witnesses on their evidence that 1992/93 was representative. Having heard the evidence and seen the witnesses we are now of the view that 1992/93 was broadly representative of all the years of assessment under appeal; the oral evidence that the investment strategy of the Appellants was consistent throughout the years of the assessments, although it became more cautious after the crash of 1987, was unchallenged. The Appellants chose to analyse the transactions in 1992/93 because their records for that year were complete whereas their records for earlier years were not complete. We have considerable sympathy with that approach as it must now be extremely difficult for any appellant to adduce evidence relating to events which took place in 1981. Under section 42 of the Taxes Management Act 1970 appeals are brought by giving written notice to the Inspector or the Board; appeals are not lodged with the Special Commissioners until either party (usually the Inland Revenue) serves notices requiring a date for the hearing to be fixed. There was no dispute that in this appeal all the notices of appeal had been served in time but the Inland Revenue did not request a hearing until January 1996. Such a lengthy delay in requesting a hearing must create difficulties for any appellant in adducing evidence relating to years of assessment going back to 1981.

The facts

15. From the evidence before us we find the following facts.

History and structure of schemes

16. Before 1 October 1969 the employees of the Post Office were civil servants and

received non-contributory civil service pensions. On that date the Post Office became a public corporation and, on the same date, it established the Post Office Staff Superannuation Scheme ("POSSS") to cover the previous service of past and current employees. In October 1981 the Post Office was reorganised and British Telecom plc was established as a public company. On 1 April 1983 British Telecom plc established the British Telecommunications Staff Superannuation Scheme ("BTSSS") (since 1 January 1993 the British Telecom Pension Scheme) ("BTPS") and 57.674% of the assets of POSSS were transferred to BTPS. On 1 April 1987 the Post Office Pension Scheme ("POPS") was established and on that date POSSS was closed to new members. BTPS is the largest single private sector pension scheme in the United Kingdom and in 1996 had a total of 371,060 members, including contributing and pensioner members and members with deferred rights; this showed little change from 1993. In 1996 POSSS had a total of 280,667 members and POPS had a total of 107,203 members. At 31 December 1993 BTPS held funds amounting to £17,196m; we were told that POSSS is about half the size of BTPS and that POPS is considerably smaller.

17. The original BTSSS established in 1983 gave by Clause 8(3) power to delegate the power to select, buy and sell investments to investment managers both external and internal "with power to manage the investment of the Fund (or part or parts thereof) at their discretion" subject to conforming to general rules of policy prescribed by the trustees and to reporting at least quarterly. Clause 13(1) provided that funds not from time to time required for application in payment of benefits or other expenses "shall ... be invested" by the trustees who were given wide powers of investment. Clause 13(3) provided,

> "The Trustees shall have power at the risk of and for the benefit of the Fund to underwrite the issue of any shares or securities in which money of the Fund could be invested. This power may be delegated to the Investment Subcommittee or to an Investment Manager."

18. The trust deed contained no power to engage in any trade. A consolidated BTPS deed of 1 January 1993 contained similar provisions with widened investment powers.

19. The consolidated POSSS trust deed of 1994 contains similar provisions to the BTPS deed. It consolidates the original 1969 deed and 25 supplemental deeds. Until 16 October 1969 clause 13 only referred to investment; on that day the words "or applied" were added after the words "shall be ... invested" in clause 13(1), with similar references to application as well as investment of funds.

20. The trust instrument in the case of POPS consisted of the Rules which were made under seal on 30 March 1987. They contain power to delegate powers to any person. There is no express reference to "investment" as such but Rule 14 authorises the trustees "for the purpose of the Scheme" to acquire any property or "enter into any contract or incur any obligation". There is no reference to underwriting.

Management

21. In 1969, when POSSS was first established, the trustees of that scheme appointed merchant banks to be its investment managers. As the fund grew, staff were recruited to manage the assets internally. This continued and, on 1 April 1983, when BTSSS was established, PosTel was set up to manage assets of both POSSS and BTSSS (later BTPS). PosTel was jointly owned by those two schemes but, on 31 March 1995, it became wholly owned by BTPS and changed its name to Hermes. Mercury and its predecessor has also been engaged as a fund manager throughout. We refer to that company as "PosTel" since that was its name throughout the period covered by the assessments. Two overseas portfolios are managed by Schroder's Investment Management ("Schroders").

22. As trustees, the Appellants make decisions about the investment strategy for the funds of the schemes and set targets for the allocation of assets between different classes of investment. These targets reflect the views of the Appellants on the appropriate balance to be struck between seeking high returns and incurring low risk. For example, the current targets for the allocation of the assets of BTPS are that 52% should be invested in United Kingdom equities, 22% in overseas equities and the balance of 26% in other forms of investment, for example, gilts, bonds and property.

23. Having delegated the management of investments with the power to underwrite the trustees have not been concerned with day-to-day investment or underwriting activity. Minutes of the BTSSS trustees on 17 May 1991 and 22 May 1992 record the trustees as noting PosTel papers on the proposed allocation of sub-underwriting between the schemes. A memorandum by the secretary of the trustees to the trustees attached to a PosTel paper read:-

> "The attached paper sets out the proposed split of sub-underwriting commission between PosTel's clients for 1992/93. The formula used for deciding the percentages was agreed a few years ago and has not given rise to any problems."
>
> The percentage allocated to BTSSS is not much changed from last year's. The amounts involved are not great in Scheme terms, but it is nevertheless a useful source of extra income. Trustees are invited to note."

1993 Report of BTPS

24. The 1993 annual report of the BTPS showed PosTel as managing 84% of the total assets of the scheme, Mercury 7% and Schroders the balance. At 31 December 1993 53% of assets were held in UK equities, £8,669m; of this £1,196m was managed by Mercury and the balance, £7,473m by PosTel. The report stated that the scheme's basic strategy was to hold most of its UK equities in a core fund matching the FT Actuaries All-Share Index; this meant that performance was roughly in line with that of the market. The report stated: "Experience has shown that this strategy has been very successful over the long run in terms of results achieved, and it also carries relatively low risk." The report stated that in addition PosTel was permitted to use its discretion to try to perform better than the Index with a proportion of its portfolio and

had succeeded in 1993; PosTel also managed a small companies portfolio with had performed successfully. Mercury managed a discretionary (ie non-index matching) portfolio with a limited range of stocks and had succeeded in its brief to perform better than the Index in 1993. The report also stated that PosTel were encouraged to keep close contacts with companies in which investments were held. The report showed £22.2m at 31 December against, "Calls on partly paid shares and underwriting commitments" under the heading, "Commitments for investments". There was no other reference to underwriting.

25. No accounts were produced for POSSS or POPS. The evidence however was that PosTel managed the UK equity funds of POSSS in the relevant years on the same basis with similar divisions between types of portfolio as for BTPS. POPS was not large enough to track the Index fully, but instead held shares in a sample of companies so as to match the risk profile and return of shares in the Index.

26. PosTel held some 3 per cent of its UK equities in the small companies portfolio and an investment trusts portfolio and the balance in the main portfolio. The main portfolio tracked the All-Share Index. However PosTel took an overweight position in some stocks and an underweight position in others, resulting in minor deviations from the index mirroring principle: we are not told how much those deviations were.

Index-tracking

27. Index-tracking involves holding the same percentage of shares ("the Index weighting percentage") in each company in the All-Share Index. At the time of the hearing the smallest company in the Index was capitalised at £45m. On 31 December 1993 the Index weighting percentage was 65%, having been reduced from the 1992 percentage because of an increase in the number of companies in the All-Share Index to over 800. In fact the largest holding (£284m) was in British Telecommunications since it had the largest capitalisation. If a company in the Index raised funds by a rights issue it was necessary for PosTel to acquire shares in order to maintain its Index weighting. Similarly if a new issue resulted in a company joining the All-Share Index, PosTel needed shares to preserve its weighting.

Small companies and investment trust portfolios

28. The small companies portfolio managed by PosTel is invested in companies with market capitalisations below a certain level. Currently £300m; in 1992/93 this portfolio had holdings in about 220 companies. At present due to their size some 40% of the companies in the small companies portfolio are also in the main portfolio. PosTel holds quite a large percentage of shares in the small companies in which it chooses to invest, possibly up to 10%. The investment trusts portfolio managed by PosTel also had some overlap with main portfolio. The small companies portfolio and the investment trust portfolio managed by PosTel operate on an active management basis, as contrasted with Index tracking which may be described as passive.

Mercury

29. Mercury operated on an active management basis. Its objective as stated in a letter of 26 February 1993 to BTPS was in the long-term to maximise the out performance

of the All-Share Index and in the short-term to achieve an annual time-weighted return greater than the Index after allowing for the standard costs of investing new money. The fund was limited to securities primarily quoted on the London Stock Exchange, predominantly but not exclusively equities. The number of equity holdings was not to exceed 100 without the approval of the trustees and Mercury were required to liaise with PosTel to ensure that the holdings of BTPS in any one company did not exceed 5 per cent of its issued capital. Except with the approval of the trustees no holding was to exceed 5 per cent of the portfolio or (if greater) 1.25 times its index weight. It was expressly stated that there were no underwriting restrictions.

Sub-underwriting

30. The sub-underwriting commissions which are in the issue in this appeal arose in varying contexts. A company listed on the London Stock Exchange might wish to raise additional finance by means of a rights issue, where existing shareholders were given the opportunity to subscribe for shares in proportion to their existing holdings at a discount (usually about 15%) to the market price and could sell those rights on the market; an unquoted company might wish to obtain a Stock Exchange listing through a new issue of shares (an initial public offering); a listed company might wish to bid for another company offering new shares with a cash alternative. Where finance was raised by means of a rights issue or an initial public offering the company needed to ensure that all the new shares were subscribed if it was to raise all the capital it required. The issue price would be fixed at a level designed to ensure success; however between the date of offer and the last acceptance date, either the market generally might fall or the particular shares may fall, resulting in undersubscription. Such a risk was always present to a greater or lesser extent. Similar considerations applied in a bid situation in that shareholders might opt for cash. Companies covered the risk that the shares would not be taken up by paying commission to an underwriter who contracted to subscribe for any shares which were not taken up.

31. The procedure on underwriting was as follows. The merchant bank or broker acting for the company making the issue normally acted as the primary underwriter and, shortly before the public announcement of the issue, agreed with the company to purchase all the unsold shares at the issue price. The primary underwriter then usually laid 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.

32. The normal rate of underwriting commission was 2% paid by the company out of the funds to be raised. The primary underwriter retained 0.5%; the stockbroker who arranged the sub-underwriting retained 0.25%; and the sub-underwriters received the remaining 1.25%, with a small extra percentage if the issue remained open for longer than 30 days. In most cases the rights issue or initial public offering was fully subscribed and the primary underwriters and the sub-underwriters received their commission without any further obligation. However if the issue was not fully subscribed the company would require the primary underwriter to purchase the unsubscribed shares at the issue price and, if the primary underwriter could sell the shares in the market at or above the issue price, he would require the sub-underwriters to purchase their proportion of the unsold shares at the issue price. So, for example, if

a sub-underwriter sub-underwrote 1.5% of the issue he had to purchase up to 1.5% of the unsubscribed shares. Such shares were known as "stick". The primary underwriter only took stick if a sub-undwriter defaulted, unless he had retained some of the risk.

33. Companies could avoid the costs of paying underwriting commissions by offering shares at such a deep discount (say 50%) to the existing share price as would guarantee that all the shares would be purchased either by existing shareholders or on the market. However, deeply discounted rights issues had not been popular in the past; the drop in share price might affect confidence among those investors who did not understand the cause; non-exempt investors who disposed of their rights might be subject to tax; and, because more shares had to be issued to raise the capital required, it was difficult for the company to maintain the dividend per share, again affecting the confidence of unsophisticated investors. Accordingly, new issues continued to be underwritten and sub-underwritten.

34. Throughout the period relevant to this appeal sub-underwriting proceeded on the basis that the terms of the issues and the underwriting were agreed by the issuing company, its bank or broker and, if different, the underwriter. The bank or broker suggested terms on which the money could be raised, and, in particular, suggested the amount of the discount. Generally the underwriting commission reflected the risk. Since that commission was usually at the standard rate, the discount was set as to tailor the risk to the commission. Generally speaking, the deeper the discount, the less the risk that the issue would not be fully taken up. As stated already, deep discounts were not popular. In practice a discount of around 15% was normal. If every issue was volatile a higher premium would be needed. The 11/4% sub-underwriting commission covered a multitude of situations; it was low relative to risk for volatile smaller companies but high for larger companies. In most issues there was no stick. However heavy underwriting losses could be sustained as happened in the case of the BP issue in 1987. It was not normal for sub-underwriters to be consulted on the underwriting terms, although a known lead sub-underwriter might be consulted. We were told that PosTel was seldom consulted but that Mercury frequently was. The terms could not of course vary from one sub-underwriter to another; sub-underwriters had to accept or reject the offer. We were not told whether they could accept in part although we assume that they could. The underwriter informed the sub-underwriter by phone of the issue; a letter was then sent by courier that morning and the initial reply was required on the same day.

35. A letter dated 31 July 1996 from UBS Ltd to Hermes in respect of a rights issue by Stagecoach Holding plc in connection with a proposed acquisition was exhibited as typical. The letter enclosed a copy of the underwriting proof of a circular with details of the proposed rights issue, details of the proposed acquisition and a notice of an extraordinary general meeting. The rights issue and acquisition were then outlined; provisional allotment letters were to be despatched on 27 August, the day of the EGM, dealings were to start, in nil paid form, on 28 August, and the last day for acceptance was to be 18 September. The letter included the following:

> "UBS Ltd and Noble Grossart Ltd ('the Underwriters') have entered into an agreement with the Company ... to underwrite the Rights Issue, of 27,786,100 new Ordinary Shares, subject to the conditions

> below. On behalf of the Company, the Underwriters have pleasure in offering you a sub-underwriting participation ... at the issue price, subject to the terms and conditions set out below ..."

The participation offered was 445,000 shares at 410 pence per share. The letter continued,

> "In consideration of your acceptance of the Sub-Underwriting Participation, you will receive a commitment commission of 1/2% ... in respect of the first 30 days of your commitment (commencing today) and a further commitment commission of 1/8% of such value for each additional period of seven days (or part thereof) up to and including the earlier of the date when the Underwriter's objections ... cease ... and the date on which when Noble Grossart Ltd on behalf of the Underwriter's is notified of the number of new Ordinary Shares for which the Underwriters are obliged to subscribe ...
>
> In the event that the conditions set out below are satisfied (or waived by us) and the Provisional Allotment Letters are duly posted, a further commission of 3/4% ... will be paid."

The letter then stated that the Sub-Underwriting Participation but not the payment of the commitment commission were conditional (inter alia) upon the passing of a resolution at the EGM and the admission to listing of the new shares. It was then stated that the Underwriters would use their best endeavours to procure subscribers at a sufficient premium to cover expenses for any shares not taken up by no later than 3pm on the second business day after the Acceptance Date. The letter continued:

> "Sub-Underwriters will be called upon to subscribe for such .... Shares only if subscribers for such .... Shares cannot be procured and any allocation to Sub-Underwriters will be notified to them as soon as possible thereafter. Payment instructions will be given at that time."

The letter requested a reply by telephone of fax by 3pm on the same day (31 July) and, if accepting, return of a letter of confirmation by 5 August. Confirmation letters were exhibited for 250,000 shares for BTPS, 145,000 shares for POSSS and 40,000 for POPS all to be registered in the name of the respective nominee companies.

Appellants' sub-underwriting practice

36. Up to this point we have been setting out the facts generally with regard to sub-underwriting. We now return to the particular Appellants. In the case of BTPS and POSSS the policy and administration of the portfolios was the same. In both schemes

the core portfolio was managed throughout by PosTel and was predominantly Index-tracking. PosTel also managed smaller companies' portfolios for each scheme and investment trust portfolios. The considerations were not identical for those later portfolios, since they were not Index-tracking funds. A separate discretionary portfolio was managed for each scheme by Mercury, which by definition was not Index-tracking. The POPS was different from the two larger schemes, in that it was only established in 1987; in 1992/93 the POPS portfolios managed by PosTel held shares in only 200 companies, in effect seeking to track sectors of the market. It was not clear whether PosTel managed smaller companies and investment trust portfolios for POPS but we assume that it did. Mercury also managed a discretionary portfolio for POPS.

37. The procedure followed by PosTel was in fact the same for all the portfolios which it managed for the Appellants. PosTel would be informed by telephone of an impending issue and on the same morning would receive by courier a letter from the issuing broker such as that at paragraph 35 above. This would be considered by an investment manager who would fill in a routine internal appraisal from with basic details of the issue and the reasons for accepting or declining it. That would take about 15 minutes. It would be approved by another member of PosTel's staff and the offer would be accepted or rejected by the 3pm time limit. The offer would be in respect of all PosTel's portfolios. PosTel would allocate the underwriting between the portfolios as appropriate and would post separate acceptance forms in respect of each scheme.

38. The first page of a sub-underwriting offer letter for an issue by Jeyes Group plc in July 1992 was also exhibited together with PosTel's internal appraisal from of one page. PosTel's appraisal form showed the issue of being 6.1 million shares by 3 for 7 rights at 385 pence; PosTel's holding was 3.161%, the underwriting offered being 120,000 shares, 1.98%; commission was 1/2% + 1/8% + 3/4% with 31 days on risk; the share price at the time of the letter was 470p, the anticipated ex rights price 4441/2p and the discount to ex-rights price 16.5%; there was a four line summary of the reasons for the issue; it was marked accepted, the main reason being marked "good fit"; the initials of the person accepting and the person approving appeared and the date 9 July 1992. The shares were split 72,000 to BTPS and 48,000 to POSSS; there was no allocation to POPS. The issue was successful, no shares being left with the underwriters; on 24 August the commission was paid, £4,158 in the case of BTPS, there being an extra 1/8% presumably because there was an additional 7 days on risk. The size of PosTel's holding is explained by the fact that Jeyes was both in the Core Index-tracking portfolios of BTPS and POSSS and their small companies portfolios. It was not in POPS portfolio.

1992/93 Underwriting

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 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.

41. Mrs Kirby was cross-examined about four of the issues underwritten where stick was taken and sales was followed. The first was an issue by Carlton Communications plc to fund a cash alternative on a take-over for Pickwick Group plc in which the schemes also held shares; 75,000 shares were underwritten, with stick of 2,184 shares which were sold on issue. She told us that the stick was unloaded because it was a small amount. Much larger sales followed because the schemes were overweight before the take-over which was accepted; subsequent sales reflected a decision to reduce the weighting on investment grounds.

42. The next issue was by TI Group plc to support a cash alternative on a bid for Dowty Group plc. The schemes were overweight in both companies before the issue. 600,000 shares were underwritten, 101,934 being taken by stick; 1,588,847 were received for the Dowty holding. PosTel supported TI's management. The schemes became more overweight as a result of the bid. The BT New Pension Scheme merged with BTPS on 1 January 1993; since it also held TI shares, BTPS became more overweight. Mrs Kirby told us that the sales were to correct the overweighting; in addition the schemes were sellers of UK equities at that time.

43. Marshalls plc made a rights issue to reduce borrowing, acquire undervalue companies and increase capital expenditure. The schemes took up rights of 204,068 shares at 75 pence; they underwrote 360,000 shares and received 260,004 stick, which were sold on the next day at 72 pence, a small loss. PosTel supported the management and the reasons for the issue. Mrs Kirby said that it looked as though they misjudged in taking up the rights and getting so much stick.

44. The last issue on which she was cross-examined was by Jupiter European Investment Trust which was underwritten by the investment trust portfolios only. This was an open offer and a conditional placing of new ordinary shares and warrants. The schemes had no holding in the company but decided to underwrite 375,000 shares at 78.5 pence, which we assume must have been close to the stock market price of the existing shares. The issued flopped with 96% of shares left with the underwriters of which the schemes' share was 360,315. The shares were sold four months later at 34p. Mrs Kirby said that this was an unhappy investment decision. We observe that the investment trust portfolio was not Mrs Kirby's responsibility. The other three holdings were her responsibility.

45. Of the other five sales within a year of receiving stick, in three there were no sales for five months and two were to fund take-over bids which PosTel supported.

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.

47. Stockbrokers who were arranging sub-underwriting would know that PosTel managed Index-tracking funds for the schemes and would know that PosTel would be likely to accept an offer of underwriting and how much it would accept. PosTel was almost invariably offered underwriting in relation to all shares in the Index. PosTel usually accepted the underwriting offered. It had no opportunity to negotiate terms except occasionally in relation to small companies where it might be approached at an earlier stage.

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 undewriting.

50. One of the most common circumstances in which underwriting was offered was rights issues. The offer would generally be open to shareholders for 3 weeks, as with the Stagecoach rights offer. 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. In most cases the decision was simple since the rights were either at a healthy premium or had no value. In the latter circumstances PosTel would anticipate receiving substantial stick and would allow the rights to lapse. In the former circumstances PosTel would anticipate receiving substantial stick and would allow the rights to lapse. In the former circumstances PosTel would accept the rights and rarely receive any stick. Sometimes

however the ex-rights price of the shares would be close to the issue price and the decision would be difficult. An example was Marshall plc (see paragraph 43 above). After a certain date the rights entitlement could not be split, so that the option of partial acceptance of the rights was no longer open.

51. Until the market crash in October 1987, when underwriters were left with large holdings in BP, underwriting was considered by PosTel to be a matter of routine. A more cautious approach was adopted thereafter but in practice the policy of supporting companies remained the dominant principle and although possibly one or two offers were declined which might have been accepted earlier, the percentage of offers declined did not increase significantly. By 1992 the practical position was recognised as policy and underwriting was again accepted as routine practice.

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 stock should be treated, in particular whether it should be valued as to the date of the 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 £653m 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 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. In 1993 PosTel underwrote a greater percentage of shares in an issue by Hawtal Whitney plc than its existing holding because the company was in trouble and PosTel wished to assist: the rescue was successful; that was a fairly exceptional case. 21 issues by small companies were underwritten in 1992/93, two of those were also in the core portfolio. Nine of the 13 issues where stick was received in 1992/93 without subsequent sales (see paragraph 40) were in the small companies portfolio. Two of the five sales referred to in paragraph 46 were of

small companies.

56. The investment trust portfolios were managed in the same way as the small companies portfolios with a separate team. Again there was some overlap with the core portfolios. In the year 1992/93 five investment issues were underwritten none of which were in the core portfolio. At paragraph 44 we have outlined the Jupiter issue which went wrong. On two issues the schemes had no prior holding, retained the shares allocated on placing and took no stick. In the other two there were prior holdings; in one rights were subscribed and stick retained; in the other the placing was accepted and retained but there was no stick.

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 the 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 stock. 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 Goobey's evidence we find the last statement illogical since there would almost always be an initial paper loss if shares were acquired as stock. 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 (see paragraph 42). 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 like. 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.

66. We have found it convenient to consider the submissions of the parties within the context of the three separate issues in the appeal.

Issue (1) - Case VI or Case I?

67. The first issue for determination in the appeal is whether the commissions were chargeable to tax under Case VI of Schedule D, and thus exempt from income tax under section 592(3), or whether the commissions were receipts of a trade chargeable to tax under Case I of Schedule D and thus not exempt under section 592(3).

68. For the Appellants Mr Flesch argued that the sub-underwriting commissions were chargeable to tax under Case VI. The Appellant trustees, through their managers, did not trade or deal in shares; they were investors and not share dealers; sub-underwriting was part of their general investment strategy and an essential part of the investment process; accordingly the sub-underwriting was incidental and ancillary to, and took its colour from, the investment activity. Any shares acquired as a result of sub-underwriting were always acquired for the purposes of investment; he cited *Imperial Tobacco Co (of Great Britain and Ireland) Ltd v. Kelly* (1943) 25 TC 292. Further, the evidence was that PosTel undertook underwriting so as to reduce the cost of the investment, to show support for companies, to ensure that it received its index

weighting percentage of new share issues, and to facilitate the capital raising process. He cited *Brown v. Richardson* [1997] STC (SCR) 233 as authority for the view that intention was relevant. He referred to Statement of Practice 14/91 of 21 November 1991 on the tax treatment of transactions in financial futures and options which, he said, supported the view that it was only transactions which were ancillary to trading transactions which gave rise to trading profits. He also referred to paragraph 8090 of the Inland Revenue Inspectors' Manual which indicated that underwriting where there was no intention of acquiring the underlying stock was likely to be trading; that was not the fact the in the present case.

69. Next, Mr Flesch argued that the intention of section 592(3) was to exempt underwriting commissions received by an exempt approved scheme as part of its normal investment activity but to tax those unusual cases where commissions were received in the course of a trade. Trading could occur, for example, where the underwriter wanted the commission and not the shares, where there was an intention to sell the underwritten shares and not to hold them as a long term investment, where there was an intention to generate income from the commissions, where there was a considerable degree of selectivity as to which shares to underwrite, where there was a business structure with employees specifically engaged to carry out the underwriting activity and where the commissions were brought into a profit and loss account. None of those factors was present in the present appeal. In particular, there was no intention to sell the shares at a profit if the issue went to a premium; if the Appellants had to take stick they could not sell at a profit and would always make a loss. If they took up their rights entitlement and the rights issue went to a premium, then a profit would be made but such profit would be made by the Appellants in their capacity as shareholders (by taking up their rights entitlements) and not in their capacity as sub-underwriters (by taking stick). Mr Flesch referred to the Investment Committee Bulletin No 8 of June 1991, of the National Association of Pension Funds Limited which contained guidelines on the taxation of underwriting activities which were agreed with the Inland Revenue in 1996; the Appellants were not trading within the terms of those guidelines.

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 sub-section 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 tax 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 a pension funds the trustees of which did not normally engage in trade. However, if, unusually, a fund did undertake underwriting in the course of a trade then that would not be exempt. Mere frequency was not enough to establish trading and, in any event, frequency had to be considered within the factual context. PosTel entered into about 5,500 sales and purchases of investments each year for the Appellants and, for the year 1992-93 PosTel had entered into 68 underwriting transactions for BTPS; it also had to be borne in mind that PosTel held shares in all the companies in the index; it only underwrote issues when it was asked to do so; Mercury only underwrote when it wanted to acquire shares at that price for investment purposes; in both cases the commission was a very small part of the total investment income of the portfolios and the Appellants did not undertake sub-

underwriting in order to earn commission. He cited *Davies v. The Shell Company of China* (1951) 32 TC 133 at pages 151 and 154 and distinguished *Cooper v. Stubbs* (1925) 10 TC 29; in the latter case the taxpayers undertook transactions in cotton futures as traders; whereas here the Appellants undertook underwriting transactions as investors, and in that case the taxpayers had no intention of buying the cotton, whereas the Appellants only wanted to buy the shares.

71. Finally, Mr Flesch pointed out that the argument of the Inland Revenue, that the underwriting commissions were profits of a trade, resulted in the anomaly that any shares acquired pursuant to the underwriting contracts were acquired as trading assets and would thereafter have to be appropriated at some later date as investments at market value. The evidence in the present appeal was that all the shares were acquired as investments and so the notion of a later appropriation was artificial; that confirmed the view that the arguments of the Inland Revenue were misconceived.

72. For the Inland Revenue Mr Brennan argued that the underwriting commissions were chargeable to tax under Case I as the profits of a trade. Section 592(3) presupposed that some exempt approved schemes could receive commissions which were chargeable otherwise than under Case VI. A Case I charge would arise where the income arose from underwriting which was habitual, organised, for reward, extensive in scope, and carried out in a business-like way. Sub-underwriting was a commercial activity and could be a trade. In support of his argument that the Appellants' sub-underwriting constituted a trade he cited *Ransom v. Higgs* (1974) 50 TC 1 at pages 79 and 88 and *Brighton College v. Marriott* (1925) 10 TC 213 at page 227 and 231. The Appellants had both investment income and underwriting income but the character of the latter was not altered by association with the former, even though the former was substantial as compared with the latter; if the Appellants were carrying on a separate trade, however small, then the profits would be taxable under Case I and not under Case VI. He cited *Religious Tract and Book Society v. Forbes* (1896) 6 TC 420. He said that Statement of Practice 14/91 dealt with a different situation: a "hedge" transaction genuinely ancillary to a capital/revenue transaction could appropriately take its capital/revenue character from the main transaction but sub-underwriting was very different.

73. Next Mr Brennan argued that the underwriting activity was not investment. The primary activity of the Appellants in sub-underwriting was to earn the commission and not to take up the shares as the shares could be, and usually were, acquired by taking up rights entitlements; the earning of commission was not investment. The commission was a separate source of income which did not arise from the shares, which did not form part of the price of the shares, and which was not credited against the cost of the shares; it was the reward for entering into a separate deal. The contention that underwriting reduced the cost of the shares acquired confused the earning of profit with applying it; the allocation of income did not determine its source, see *Mersey Docks and Harbour Board v. Lucas* (1883) 2 TC 25. The proper inference from the evidence was that the Appellants underwrote in order to make useful extra income when it was appropriate to do so. The intention of the Appellants was not relevant if the activity was in fact a trade and he cited *Inland Revenue Commissioners v. Newcastle Breweries Ltd* (1927) 12 TC 927. He distinguished *Brown v. Richardson* where the issue was whether a holiday letting was made "with a view to the realisation of profits".

74. Thirdly, Mr Brennan argued that the proper scope of the Case VI charge was casual isolated transactions and there was nothing casual or isolated about the Appellants' underwriting. He cited *Ryall v. Hoare* (1923) 8 TC 251 and *Lyons v. Cowcher* (1926) 10 TC 438. He distinguished *Cooper v. Stubbs* 10 TC 29 where the Court of Appeal had been of the view that there had been a trade but were unwilling to interfere with a finding of the Special Commissioners that there had been no trade; that decision had been reached before *Edwards v. Bairstow & Harrison* [1956] AC 14 and, he submitted, would now be differently decided.

75. Finally, Mr Brennan argued that the fact that shares acquired as stick were acquired as trading assets and had later to be appropriated to investment account did not alter the nature of the Appellants' trading activity.

76. In considering the submissions of the parties we start by reminding ourselves that section 592(3) exempts underwriting commissions if they would be chargeable to tax under Case VI of Schedule D and that it was the view of the Inland Revenue that they were receipts of a trade chargeable under Case I. We therefore look at the words of Case I and Case VI of Schedule D which are found in section 18 of the Taxes Act. The relevant part of that section provides:

> "(2) Tax under Schedule D shall be charged under the Cases set out in subsection (3) below ...
>
> (3) Case I tax in respect of any trade ....
>
> Case VI tax in respect of any annual profits or gains not falling under any other Case of Schedule D ..."

77. We first consider whether there is any reason why the underwriting activities could not be chargeable under Case VI with particular reference to the argument of Mr Brennan that Case VI only applies to casual and isolated transactions. We note that the actual wording of Case VI itself does not support that view in that it refers to "annual profits or gains" rather than to "casual profits or gains". Three authorities were cited to us on the scope of Case VI.

78. In *Ryall v. Hoare* (1923) 8 TC 521 the taxpayers, who were the directors of a company, guaranteed the company's overdraft the company paying them a commission of 2% on the amount guaranteed. The original guarantee was for one year but was renewed the following year when commission at the same rate was also paid. The taxpayers argued that the commissions arose from casual, isolated and exceptional transactions and were not chargeable to income tax at all. Rowlatt J held that the commissions were annual profits or gains within the meaning of Case VI of Schedule D and said at page 525,

> "Without pretending to give an exhaustive definition I think that one may take it as clear that where an emolument accrues, by virtue of some service rendered by way of action or permission, or both, at any rate that is included within the words 'profits or gains'. But

> the question is whether in this case it is an 'annual profit or gain'".

Later at page 526 he said,

> "it seems to me that 'annual' here can only mean 'in any year' and that the 'annual profits or gains' means 'profits or gains in any year as the succession of the years comes round'."

79. In *Lyons v. Cowcher* 10 TC 438 the taxpayer received a single underwriting commission in a period of three years and Rowlatt J following his decision *Ryall v. Hoare*, held that the commission, even though not recurring, was an annual profit or gain within the meaning of Case VI. Although in these two appeals Rowlatt J held that the commissions were within Case VI, with other isolated or casual profits, in neither case did he say or even suggest that Case VI was confined to casual profits. There was no suggestion that the commissions were profits or gains of a trade; the argument was whether they were taxable at all.

80. In *Cooper v. Stubbs* 10 TC 29 two partners in a firm of cotton brokers undertook, over a period of eight years, speculations in the purchase and sale of cotton futures, not in order to obtain cotton but to make a profit. The Special Commissioners held that "the respondents did not deal in future delivery contracts so habitually and systematically as to constitute these dealings the carrying on of a trade" so as to be assessable under Case I; they further held that the dealings were gambling transactions so that the profits were not assessable under Case VI either. The Court of Appeal held that the finding that the transactions were not a trade was a finding of fact with which they could not interfere but that the profits were annual profits or gains assessable under Case VI. Lord Justice Warrington said this at page 52:

> "... they were contracts entered into with a view to making a profit on a rise or fall, as the case may be, in the market price of the contracts. They extended over a considerable number of years. There were large numbers of transactions in each of those years, from which in some years the Respondent derived considerable revenue; and for myself I cannot see what there is to exclude that revenue from the tax which is charged under Schedule D."

In the context Lord Justice Warrington was of course referring to Case VI.

81. From those cases it is clear that while Case VI will cover casual or isolated transactions it is not confined to them. Indeed it should be remembered that Case VI expressly covers such continuing activities as furnished lettings. We conclude that Case VI is sufficiently wide to include the commissions received by the Appellants so long, of course, as those commissions are not receipts of a trade within Case I. We therefore turn to consider whether they are taxable under Case I and we begin by considering what is meant by "trade".

82. The immediate difficulty is that the traditional badges of trade identified by the *Royal Commission on the Taxation of Profits and Income* (1955) Cmnd 9414, para 114 and the vast majority of the leading cases on what constitutes a trade were concerned with the acquisition and disposal of assets rather than with the provision of services or the acceptance or incurring of contingent liabilities.

83. In *Ransom v. Higgs* 50 TC 1 where the House of Lords considered a situation where the taxpayer had neither bought nor sold anything, Lord Reid said this at page 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 operations of a commercial character by which the trader provides to customers for reward some kind of goods or services."

Lord Wilberforce said this at page 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 services for reward ... there must be something which the trade offers to provide by way of business."

84. The lack of precision in the opinions of two of the most distinguished Law Lords of recent years shows how elusive the concept of trade is. Lord Reid spoke of "a variety of meanings", "sometimes" and "commonly"; Lord Wilberforce spoke of "cannot be precisely defined", "normally" and "sometimes a matter of degree". *Ransom v. Higgs* was of course a difficult case. But the formulation of a test in the present case is no easier. 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. What is clear is that the question whether an activity amounts to a trade must be determined in the light of the facts and circumstances of the particular case and is often, as it is here, a matter of degree. We consider first the transactions in the core portfolios of BTPS and POSSS and then consider whether any of the transactions in the other portfolios should be differentiated.

85. We start by considering the subject matter of the transactions, here the sub-underwriting of issues of shares in return for a commission. Viewed in the abstract sub-underwriting has features indicative of a trade. Its essence is the acceptance of a risk for reward. The economics are based on the assumption that in most cases there

will be no stick, but that in some there will. By its very nature sub-underwriting is mainly undertaken by relatively substantial and sophisticated persons or institutions capable of taking a speedy decision and assuming a substantial risk. It is clear from the evidence that sub-underwriting was only offered to a person when there was a reasonable likelihood of acceptance: the time scale dictated this. It is also clear that the sub-underwriter had to be a person or institution who could be relied on to meet any obligation arising out of the sub-underwriting.

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. It is not legitimate to take account of the fact that the predecessor of section 592(3) was only enacted in 1970. The logic is therefore that underwriting by exempt approved schemes is 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, while paying lip-service 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.

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. It is however to be noted that neither manager had a separate organisation or division devoted to sub-underwriting and neither actively solicited sub-underwriting or sought to increase the amount offered; these would have been pointers to trading. If PosTel "offered" a service of sub-underwriting on behalf of the schemes, it was in the sense of allowing it to be known that they would normally accept offers of sub-underwriting. It is also important that the schemes undertook sub-underwriting as opposed to underwriting; clearly the activity of a lead underwriter of an issue who underwrites the primary risk and then lays it off in its entirety is very different from the passive activity of sub-underwriting. On Mrs Kirby's evidence each sub-underwriting transaction took no more than fifteen minutes of one investment fund manager's time; no doubt additional time was spent on subsequent paperwork.

89. The sub-underwriting activity of the schemes through PosTel in relation to the core funds was clearly habitual, since as a matter of policy all offers were accepted unless there was a reason to the contrary. Again however it is to be remembered that

the offers were made because acceptance was anticipated; the offer was to underwrite a specific number of shares; if it was not accepted another sub-underwriter would need to be found within a few hours.

90. In 1992-93 68 issues were underwritten, between two and three a fortnight on average. In some contexts for example land transactions this would constitute a high level of frequency and regularity. Mr Flesch relied upon Jenkins LJ in *Davies v. The Shell Company of China* 32 TC 138, when he said at page 155,

> "... 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 transaction in question is a trading transaction; you have to look at the transaction and see what its nature was; ..."

These were very large institutions for whom PosTel effected some 5000 purchases and sales in 1992/93, around 20 per working day. Furthermore the frequency arose from the implementation of the Index-tracking strategy.

91. Another factor is the length of the transactions. Again this is more obviously relevant in cases of the purchase and sale of assets. The length of sub-underwriting transactions themselves was governed by the terms of the issue over which PosTel had no influence. It would have been quite different if the risk or part had been laid off either with a sub-sub-underwriter or by a put option; it was not. It is however relevant in our view to consider the treatment of shares taken as stick. We do this under the surrounding circumstances.

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 were trading. These are all features which are characteristic of sub-underwriting in respect of exempt-approved schemes. In our judgment the crucial factor is the motive viewed not only subjectively but also objectively in the light of the surrounding circumstances.

93. We consider next the surrounding circumstances and in particular the submission of Mr Flesch 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 process, see *Imperial Tobacco Co v. Kelly* 25 TC 292 and *Davies v. The Shell Company of China*.

94. In *Imperial Tobacco* the appellant customarily bought dollars in advance solely in order to pay for tobacco leaf which it purchased from the United States of America. When war broke out in 1939 the appellant had to cease its purchase of tobacco and was required to sell its surplus dollars to the Treasury; as the dollar had strengthened against the pound since the surplus dollars were purchased this gave rise to an exchange profit, which the Inland Revenue assessed to tax under Case I of Schedule D as profits from a trade. The appellant argued unsuccessfully that the exchange profit was a realised appreciation of a temporary investment in foreign currency and was not

assessable to income tax. Lord Greene MR said this at page 300,

> "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."

Later on the same page he said,

> "To reduce the matter to its simplest elements, the Appellant Company has sold a surplus stock of dollars which it had acquired for the purpose of effecting a transaction on revenue account. If the transaction is regarded in that light, it seems to me it is precisely on all fours with the case of any trader who, having acquired commodities for the purposes of carrying out a contract, which falls under the head of revenue for the purpose of assessment under Schedule D, Case I, then finds that he has bought more than he ultimately needs and proceeds to sell the surplus. In that case it could not be suggested that the profit so made was anything but income. It has an income character impressed upon it from the very first."

95. In *Davies v. The Shell Company of China* 32 TC 138, where exchange profits made on a number of agents' deposits were held to be capital profits and not income, Jenkins LJ said at page 151,

> "... 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."

Later he said this at page 154,

> "The real question in the case, in my view, must be whether, looking at the nature of the Company's business, the nature of the receipts represented by the agents' deposits and of the liabilities represented by the company's obligations as to their repayment, and the terms of the documents governing these receipts and liabilities,

> the transactions with respect to the agents' deposits were trading transactions or not.
>
> If the taking by the Company of such a deposit was in truth a transaction in its trade then I think it must follow ... that any profit resulting from that transaction, whether due to an alteration in exchange rates or otherwise, must *prima facie* be a trading profit.
>
> The real issue is whether the taking of each deposit on the terms of the relative deposit agreement was a trading transaction or not."

96. In considering the circumstances in which the underwriting transactions were undertaken we consider it relevant that they were undertaken purely within the context of the holding of the shares for the purposes of the Appellants' schemes. The underwriting was offered to PosTel because the Appellants already held a proportion of all the shares in the index for the purposes of their investment strategy of index tracking. The underwriting was offered in tandem with offers of shares broadly mirroring the shares underwritten. The Appellants' business was the making and the managing of investments of exempt approved schemes and the underwriting was in fact conducted as an integral part of the investment process. It is clear that the shares acquired as stick were in fact regarded by the Appellants from the very beginning as investments. It follows therefore that if they were categorised at issue as trading stock they must have been instantly appropriated as investments on the principle of *Starkey v. Wernher* (1955) 36 TC 275, which would almost invariably be as a loss. We observe here that such a treatment in this case appears to us be highly artificial in commercial terms. We return to this aspect. We do not find *Religious Tract* to be of assistance since the colportage was clearly distinct from the trade of bookselling from a shop.

97. When considering whether the underwriting commissions were earned as part of a trade it is clearly necessary the ambit of the trade of which it is said that they form part. In the *Religious Tract* case the colportage was clearly distinct from the trade of bookselling from the shop. It is clear beyond doubt that the acquisition and holding of shares for the core portfolio and periodic disposal of part of holdings was not trading although the Index-tracking involved a high degree of activity to main the required Index weighting. The sub-underwriting was usually associated with a rights issue or with a new issue offered to the schemes. It is unclear whether the Revenue contend that in considering the sub-underwriting the schemes were trading but when considering whether to take up the rights they were not. In fact it is clear that the two were closely linked and that if it appeared that the schemes would be left with an appreciable amount of stick the rights were allowed schemes would be left with an appreciable amount of stick the rights were allowed to lapse. On occasion, however, PosTel misjudged the market and having taken up the rights took stick, see Marshalls plc (para 43 above); presumably the sale would have been trading, as perhaps Carlton Communications plc (para 41). The date of appropriation of the Jupiter shares (paragraph 44) would depend on whether it was decided to retain them as an investment; if the evidence that they were underwritten as a potential investment is regarded as material, the date of appropriation would be very difficult to determine

unless a contemporaneous record was kept. While difficulty in delineating the boundary of a trade does not mean that an activity is not a trade, when it is closely linked to another activity it may well be that on a proper analysis it is part of that activity and not a separate trade.

98. We now consider the motive and intention of the Appellants. Mr Flesch argued that motive was relevant and cited *Brown v. Richardson* whereas Mr Brennan argued that it was not relevant and cited *Newcastle Breweries*. We have not found the decision in *Brown v. Richardson* (1997) to be of great assistance as it was decided on the particular words of section 381(4) of the Taxes Act and the issue was whether profits could "reasonably have been expected to be realised". The Special Commissioner decided that that was a subjective test and so it followed that intention was relevant. The same words are not in issue in the present appeal.

99. In *Newcastle Breweries* 12 TC 927 the respondent was a brewer and kept large stocks of rum, some of which were requisitioned by the Admiralty in 1918 when some payment was made. In 1922 further compensation was paid and the respondent argued that the additional payment was not a trading profit for the purposes of Excess Profits Duty. The House of Lords held that the additional payment was a profit arising from the respondent's trade and had to be included in the accounts for 1918 when the rum had been taken over. At page 947 Warrington LJ in the Court of Appeal said this,

> "... I cannot see that the absence of the will to trade can make any difference, if the transaction is in fact a commercial transaction giving rise to profit."

It is important to note that the rum was purchased for trade purposes and was held as stock-in-trade, see Lord Phillimore in the House of Lords where he said at page 954,

> "The rum was purchased for trade purposes, and the particular sale was none the less a trade sale because it was forced upon the appellant company."

100. It is clear that the absence of an intention to trade cannot negative objective facts and circumstances which indicate a trade. However motive is relevant if the facts are otherwise ambiguous, see *Iswera v. Ceylon Commissioners of Inland Revenue* [1965] 1 WLR 663. In *Ransom v. Higgs* Lord Wilberforce clearly considered that motive could be relevant. In *Imperial Tobacco* Lord Greene specifically referred to the purpose for which the tobacco was acquired. As the present appeal concerns sub-underwriting transactions which could either be trading or not we are of the view that the intention of the Appellants is important.

101. Having heard the evidence and seen the witnesses we have concluded that the Appellants 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. The witnesses rationalised the policies in a variety of ways but all were in essence ancillary to their investment strategy. Mr Brennan pointed out that it was not

necessary to sub-undewrite in order to acquire the shares as they could have been acquired simply by taking up rights entitlements. However the refusal by the Appellants of sub-underwriting might always have an adverse effect on an issue and thus on their underlying investment. The observation that refusal of sub-underwriting would, if an issue were successful, involve value passing out of the holding appears to us valid. So also does the view that by underwriting the Appellants obtained a commission which effectively reduced the cost of the acquisition of the shares, although of course the shares were capital assets and the commissions were income so that the commissions would not, in accountancy terms, reduce the cost of the shares. The optimum position for the Appellants was to underwrite an issue, receive the commission, take up the rights and not be allocated stick. In that way the index weighting percentage would be maintained at the least possible cost.

102. We accept of course Mr Brennan's submission based on *Mersey Docks and Harbour Board v. Lucas* (1883) 2 TC 25 that the use to which the commissions were put should not be confused with the reason for underwriting.

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. The answer depends on the nature of the Appellants' activities and their motive. It is we consider important that sub-underwriting was not regarded as a separate profit-centre nor was it treated as such in the accounts. We accept Mr Flesch's submission that the sub-underwriting in fact formed an integral part of the investment process and took its colour therefrom. This seems to us a logical result and distinguishes these activities from those in which scheme trustees might sub-underwrite issues where they do not hold stock and do not intend to retain any stick.

104. Having concluded that the sub-underwriting activities of the core funds were not trading we turn to the Mercury funds which were managed on a discretionary basis. The frequency of transactions was less than for the core funds. Mercury's part was less passive in that it was often consulted on the terms. Being discretionary manages Mercury had a real choice and only underwrote when willing to acquire and retain stock at the underwritten price. Since only eight issues were underwritten in 1992/93 it is not easy to see a pattern, but TI was the only holding where stick was sold but only after 9 months. The underwriting receipts were just over one quarter of one per cent of underwriting income. We do not consider that the differences in relation to Mercury are such as to cause the tax treatment to differ from the core funds. We hold that the Appellants were not trading in relation to the Mercury funds.

105. In the case of small companies PosTel's underwriting support for issues was more important to the company because its stake was larger. It would clearly be damaging for such a company if it became known that PosTel had declined underwriting, this in turn would affect the Appellant's investment. The frequency of transaction is higher then with the core portfolios but that simply reflects a higher proportion of issues by small companies due to their need for capital. PosTel played a more active part in sub-underwriting in that it was often consulted earlier, however it did not solicit underwriting. Having considered the pattern of underwriting of small companies we do not regard it as indicative of an intention to trade. Again there is no indication of underwriting where stick was not to be retained. We do not regard the

underwriting activities in relation to small companies as trading.

106. Finally we consider the investment trust portfolios. There was less evidence as to these but the frequency of underwriting was much lower than with small companies. In three of the five issues underwritten there was no prior holding. In fact in all two the underwriting commission was a commitment fee on placing where the portfolios in effect underwrote their own acceptance of the placing. Here the investment connection was even greater. We find that the underwriting for these portfolios was not trading.

107. In conclusion on this issue we find that the circumstances of the transactions viewed objectively do not indicate trading and at the most were ambiguous. Consideration of the intention or motive of the Appellants acting through their managers gives no indication whatsoever of an intention to trade and in fact demonstrates that the activities were regarded as incidental and ancillary to investment and to the advance result of the overall investment objectives. We also record that Mr Brennan did not make any attempt to distinguish the activities of the different managers or in respect of the different portfolios.

108. Accordingly, our decision on the first issue in the appeal is that the commissions were chargeable to tax under Case VI of Schedule D and were thus exempt from income tax under section 592(3). Having reached that finding the appeal must be allowed and it is not strictly necessary to consider the Appellants' two alternative arguments. However in case of an appeal on the first issue it is appropriate to give our conclusions on these issues also.

Issue (2) - Were the sub-underwriting transactions options contracts?

109. The second issue for determination in the appeal is whether the sub-underwriting transactions were options contracts within the meaning of section 659A which applied from 26 July 1990.

110. Mr Flesch argued that a sub-underwriting transaction was a put option under which the principal underwriter could, in return for the commission, put a specified number of shares, or some of them, on the sub-underwriter on a specified date at a specified price and in specified circumstances. He referred to Research Paper 6, published by the Office of Fair Trading in November 1994, written by Mr Paul Marsh of the London Business School and entitled "Underwriting of Rights Issues", where at page 8 Mr Marsh stated that it had long been recognised that underwriting was a put option purchased by the company. Mr Flesch contended that such a put option qualified as an "options contract" within the meaning of section 659A. Mr Flesch accepted that the draftsman of section 659A probably did not have underwriting in mind because he would have assumed that such commissions were already exempt under section 592(3); however the words "option contracts" had a very wide meaning and could include underwriting transactions. From 26 July 1990 section 659A clearly and deliberately extended the scope of the old section 659 which was limited to traded options. The new section 659A included all options contracts in the meaning of investments and also, by section 659A(1)(b), treated all income from options contracts, even trading income, as income from investments.

111. Mr Brennan argued that agreements to sub-underwrite were not options contracts within the meaning of section 659A and so were not exempt under section 595(2) then section 592(3) was otiose. In any event sub-underwriting contracts were not put options because they gave rise to a contingent liability; they related to an indeterminate amount of stock; they were subject to conditions which were outside the control of the underwriter; and they were only exercisable at the end of a period. Sub-underwriting contracts were not normally described as options contracts. Further, the trust deeds and the management agreements relating to the Appellants' schemes gave separate powers to the trustees and the managers to enter into options and to underwrite.

112. In considering the submissions of the parties on the second issue in the appeal we note that section 659A only applies from 26 July 1990. Before that date section 659 read:

> "For the purposes of [section 595(2) inter alia] ... a contract entered into in the course of dealing in financial futures or traded options shall be regarded as an investment; and in this section 'traded option' means an option which is for the time being quoted on a recognised stock exchange or on the London International Finance Futures Exchange."

113. Accordingly, we agree with Mr Flesch that the new section 659A is much wider than the old section. We also record that Mr Ross Goobey gave evidence that, in his opinion, underwriting contracts were in their commercial effect put options and that Mrs Kirby said that you could from an investment point of view regard sub-underwriting as a put option. However, what we have to decide is what the terms mean in the context in which they have been used. Furthermore it is quite clear that in the City the term "option contract" is not generally used to describe underwriting or sub-underwriting whatever the similarity in economic effect.

114. In order to consider the meaning of section 659A it is necessary to view the scheme of section 592 as a whole. That section exempts from income tax certain income of exempt approved schemes which is applied for the purpose of those schemes. Section 592(2) exempts investments and deposits and section 592(2) exempts underwriting commissions chargeable under Case VI. Section 659A clarifies and extends the meaning of the word "investments" in section 592(2) and must, we think, therefore be read as if it formed part of section 592(2). However, Parliament, having enacted a wide and general exemption for investments (including options contracts) in section 592(2), then proceeds to deal specifically with underwriting commissions in section 592(3). It seems to us, therefore, that it must have been the intention of Parliament, whether underwriting transactions are options contracts or not, that underwriting commissions should be taxed only under the specific subsection 592(3) and not under the more general subsection 592(2). It follows that, in our view, Parliament meant, within the context of sections 659A and 592(2), that the words "option contracts" did not include sub-underwriting transactions.

115. Our decision on the second issue for determination in the appeal is, therefore,

that sub-underwriting transactions are not options contracts within the meaning of section 659A.

Issue (3) - Are the commissions income arising from "other property" within the meaning of section 686(2)(c)?

116. The third issue for determination in this appeal is whether the commissions are income arising from "other property" within the meaning of section 686(2)(c).

117. Mr Flesch argued that the commissions were not liable to the additional rate of tax applicable to trusts because they were income arising from "other property" within the meaning of section 686(2)(c). The reference in that section to investments and deposits reflected the same reference in section 592(2) but the words "other property" went wider than that. "Property" was a word of very wide meaning and could include an underwriting contract or a trade in underwriting. He referred to section 65(3), which applied to income tax chargeable under Case IV or V of Schedule D from income derived from a trade; as section 18(3) provided that Case V of Schedule D applied to income arising out of foreign possessions it followed that the Taxes Act assumed that a trade could be a possession. As a trade was a possession for the purposes of section 65(3) it could therefore be "other property" within section 686(2)(c). The intention of the section was clearly to exclude from the additional rate the income of pension funds.

118. Mr Brennan argued that the underwriting trade did not constitute "other property held" for the purposes of pension schemes. "Property" had to be construed *eiusdem generis* with "investments" and "deposits" and could include, for example, real property or intellectual property but a trade was not, in this context, property. Section 18(1) distinguished profits and gains arising from a trade from profits and gains arising from "any kind of property"; where a trading activity consisted of the making of contracts, the income was "from" the trade and not "from" the property. An intention to exempt trading income would have been expressed.

119. In our view, the intention of section 686(2)(c), which exempts from the additional rate of tax applicable to trusts income from investments, deposits or other property held for the purposes of a pension scheme, is to give the exemption to the normal income of a pension scheme; pensions schemes can hold, as well as investments and deposits, other income-producing assets and so the intention of the section is to exempt the income from such assets. However, pension schemes do not normally engage in trade and, although a pension scheme could trade, and although a trade might, in some contexts, be regarded as property, in our view a trade would not be "property held" within the meaning of the section. Mr Brennan referred to the provisions of section 18(1) which, for the purposes of Schedule D, distinguishes between the annual profits or gains arising "from any kind of property" and annual profits or gains arising from "any trade, profession or vocation". In our view, having regard to the scheme and purpose of section 686(2)(c), that is a distinction which equally applies when considering section 686(2)(c). Furthermore in the context we do not consider that sub-underwriting contracts come within "property held" although a contract is incorporeal property. Indeed it seems to us that, on Mr Flesch's construction, the ambit of section 686(2)(c) would include any income whatsoever; if this was intended it would have been simple for the draftsman to say so in terms.

120. Accordingly, we conclude, on the third issue for determination in the appeal, that the commissions were not income arising from "other property" within the meaning of section 686(2)(c).

121. We summarise our decisions on the three issues in the appeal as:

> "(1) that the income from sub-underwriting was chargeable to tax under Case VI of Schedule D and thus was exempt from income tax under section 592(3); (2) that the sub-underwriting transactions were not options contracts within the meaning of section 659A; and (3) that the income from sub-underwriting was not income arising from "other property" within the meaning of section 686(2)(c).

122. This appeal is, therefore, allowed and the assessments are discharged.