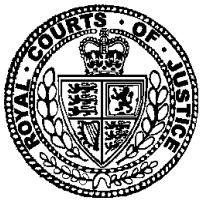

Neutral Citation Number: [2021] EWCA Civ 1804

Case No: A3/2020/2024

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
Mrs Justice Falk and Judge Thomas Scott
[2020] UKUT 253 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 3 December 2021

Before :

LORD JUSTICE GREEN
LORD JUSTICE ARNOLD
and
LORD JUSTICE SNOWDEN

- -

Between :

JOHN CHARMAN	**Appellant**
- and -	
THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Respondents**

- -
- -

Hui Ling McCarthy QC (instructed by **Withers LLP**) for the **Appellant**
Akash Nawbatt QC and Sebastian Purnell (instructed by **General Counsel and Solicitors to HM Revenue and Customs**) for the **Respondents**

Hearing dates : 17-18 November 2021

- -

Approved Judgment

Covid-19 Protocol: This judgment was handed down remotely by circulation to the parties' representatives by email, release to BAILII and publication on the Courts and Tribunals Judiciary website. The date and time for hand-down is deemed to be at 10:30am on 3 December 2021

Lord Justice Arnold:

Introduction

1. This is an appeal by John Charman against a decision of the Upper Tribunal (Tax and Chancery Chamber) (Falk J and Judge Thomas Scott) ("the UT") dated 27 August 2020 [2020] UKUT 253 (TCC) allowing an appeal by the Commissioners for Her Majesty's Revenue and Customs ("HMRC") and dismissing an appeal by Mr Charman against a decision of the First-Tier Tribunal (Tax Chamber) (Judge Rachel Short and Mrs Shameem Akhtar) ("the FTT") dated 20 December 2018 [2018] UKFTT 765 (TC) concerning the taxation of sums realised by Mr Charman from the exercise of certain share options and of his receipt of certain shares.

The facts

2. Mr Charman was born in the UK. He was employed in the UK until 2001, by which time he was a senior executive in the insurance industry. In April 2001 Mr Charman began discussions with a US company, MMC Capital Inc ("MMC"), about setting up a new insurance company in Bermuda. In late November 2001 the new company, Axis Specialty Limited ("Axis Specialty"), started trading, with Mr Charman as its President and Chief Executive Officer.

3. Mr Charman's employment contract with Axis Specialty was dated 20 November 2001. A Share Purchase Option Agreement was appended to his employment contract, under which Mr Charman was granted options to purchase 253,139 Axis Specialty shares with effect from 20 November 2001. The options were stated to vest in three equal tranches on the first, second and third anniversaries of 20 November 2001. The Agreement recited that the options were an inducement to Mr Charman to enter into the employment contract.

4. With effect from 19 September 2002, Mr Charman was awarded 50,000 shares in Axis Specialty (the "Axis Specialty Restricted Shares"). Although registered in Mr Charman's name, the shares were restricted (in particular, being subject to prohibitions on sale or transfer and the withholding of dividend payments by the company) until 19 September 2005.

5. On 31 December 2002 Axis Specialty was recapitalised. As part of the recapitalisation, Axis Specialty became a wholly-owned subsidiary of a new holding company, Axis Capital Holdings Limited ("Axis Capital"). To achieve this, Mr Charman and the other shareholders in Axis Specialty exchanged their Axis Specialty shares for shares in Axis Capital which in Mr Charman's case were also restricted (the "Axis Capital Restricted Shares"). Following the exchange, Mr Charman's Axis Specialty Restricted Shares were cancelled.

6. On 9 January 2003 Mr Charman received a Notice of Stock Option Grant, stated to be effective as of 1 October 2001, pursuant to Axis Speciality's Long-Term Equity Compensation Plan. Under that Notice, Mr Charman was awarded options over 253,139 Axis Specialty shares. The options were expressed to vest in three equal tranches on the first, second and third anniversaries of 1 October 2001. Although the options were stated to be over shares in Axis Specialty, as a result of the share-for-share exchange in practice they were over an equivalent number of shares in Axis Capital. Despite the

apparent duplication between the options granted in November 2001 and those granted with effect from October 2001 under the Notice of Stock Option Grant, it is common ground that Mr Charman was not awarded options over two lots of shares. The FTT found that the 2003 documents superseded the 2001 documents with respect to the second and third tranches, which had not vested as at 9 January 2003, and that finding has not been challenged by either party.

7. On 30 June 2003 there was a stock split in respect of Axis Capital shares which increased the number of Mr Charman's Axis Capital Restricted Shares to 400,000, and the number of shares over which his share options were exercisable to 2,025,112.

8. The FTT found that Mr Charman was resident in the UK until 21 November 2003, when he ceased to be UK resident. There has been no challenge by either party to those findings.

9. The restrictions on Mr Charman's Axis Capital Restricted Shares were lifted on 19 September 2005, at which point they were worth about $11.5 million.

10. On 19 and 20 March 2008 Mr Charman exercised some of his share options and sold the shares, realising in total approximately $53 million and making a profit of around $33 million.

The proceedings

11. HMRC issued various closure notices and discovery assessments in respect of the sums realised by Mr Charman from exercising his share options and in respect of the Axis Capital Restricted Shares. Mr Charman appealed to the FTT against the notices and assessments.

12. The FTT concluded that:

    i) Mr Charman acquired a "securities option" for the purposes of Chapter 5 of Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") on each occasion when a tranche of the options vested. He did not acquire such a right when the options were granted in 2001. This meant that he acquired a securities option when he was UK resident as regards the first two tranches, but after he had ceased to be UK resident as regards the third tranche. By virtue of section 476 ITEPA, Mr Charman was liable to UK tax when he exercised the options which vested under the first two tranches, even though he was no longer UK resident by then. He was not liable to UK tax on exercise of the options which vested under the third tranche, as a result of section 474(1) ITEPA.

    ii) Mr Charman acquired his interest in the Axis Capital Restricted Shares "as a director or employee" of Axis Specialty for the purposes of Chapter 2 of Part 7 of ITEPA, and he was accordingly chargeable to income tax under that chapter when his interest in those shares ceased to be conditional i.e. when the restrictions were lifted.

13. HMRC appealed to the UT against the FTT's conclusion that Mr Charman was not liable to tax in respect of the options which vested under the third tranche, arguing that a right to acquire securities arose when the options were granted rather than when each

tranche subsequently vested. Mr Charman appealed against the conclusion that the Axis Capital Restricted Shares were acquired by him "as a director or employee", arguing that he acquired his Axis Capital Restricted Shares in his capacity as a shareholder in Axis Specialty. The UT allowed HMRC's appeal and dismissed Mr Charman's appeal.

14. The UT granted Mr Charman permission to appeal to this Court on both issues.

Issue 1: Did Mr Charman acquire "a right to acquire shares" when the options were granted or when they vested?

15. The first issue is whether Mr Charman acquired a "securities option", that is to say, "a right to acquire securities", for the purposes of Chapter 5 of Part 7 of ITEPA in respect of the third tranche of options when the options were granted on 1 October 2001 or when the options vested on 1 October 2004. As explained above, the reason why this matters is that Mr Charman was resident in the UK on 1 October 2001, but not on 1 October 2004.

The contractual provisions

16. The contractual provisions governing the grant, vesting and exercise of the share options are set out in the UT's decision at [23]-[25]. Their effect, so far as relevant to the appeal, can be summarised as follows:

    i) The Share Purchase Option Agreement provided that Axis Specialty "hereby unconditionally grants to the Option Holder, effective as of the Grant Date, the right and option to purchase 253,139 shares … on the terms and conditions hereinafter set forth". Similar language was contained in the Stock Option Agreement.

    ii) The right to exercise each tranche of the options vested in Mr Charman provided that he was still an employee on the relevant date.

    iii) Mr Charman was entitled to exercise his options only to the extent they had vested.

    iv) The options expired 10 years after the date of their grant, subject to earlier termination if Mr Charman's employment was terminated.

    v) If Mr Charman's employment terminated, he could exercise the options at any time before they expired provided that they had vested prior to the termination of employment. In this situation the options expired on a date which depended on the reason for the termination.

    vi) The options could not be sold, transferred, pledged, assigned or otherwise alienated or hypothecated except by will or upon descent. Thus they were non-transferrable during Mr Charman's lifetime and could only be exercised by him.

    vii) The options became immediately exercisable in the event of a change in control of the company.

The legislation

17. The applicable provisions for this part of the case are those contained in ITEPA as amended by the Finance Act 2003. So far as relevant they are in the following terms:

"**Part 7 Employment income: income and exemptions relating to securities**

Chapter 1 Introduction

Interpretation of Chapters 1 to 5

420 Meaning of 'securities' etc

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

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

(8) In this Chapter and Chapters 2 to 5—

…

'securities option' means a right to acquire securities …

Chapter 5 Securities options

Introduction

471 Options to which this Chapter applies

(1) This Chapter applies to a securities option acquired by a person where the right or opportunity to acquire the securities option is available by reason of an employment of that person or any other person.

…

(5) In this Chapter—

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

…

'employment-related securities option' means a securities option to which this Chapter applies.

472 Associated persons

(1) For the purposes of this Chapter the following are 'associated persons' in relation to an employment-related securities option—

(a) the person who acquired the employment-related securities option on the acquisition,

(b) (if different) the employee …

473 Introduction to taxation of securities options

(1) The starting-point is that section 475 contains an exemption from the liability to tax that might otherwise arise under-

(a) Chapter 1 of Part 3 (earnings), or

(b) Chapter 10 of that Part (taxable benefits: residual liability to charge),

when an employment-related securities option is acquired.

(2) Liability to tax may arise, when securities are acquired pursuant to the employment-related securities option, under—

…

(c) section 476 (acquisition of securities pursuant to securities option).

(3) Liability to tax may also arise by virtue of section 476 when—

(a) the employment-related securities option is assigned or released, or

(b) a benefit is received in connection with the employment-related securities option.

(4) There are special rules relating to share options acquired under—

(a) approved SAYE option schemes (see Chapter 7 of this Part),

(b) approved CSOP schemes (see Chapter 8 of this Part), or

(c) enterprise management incentives (see Chapter 9 of this Part).

474 Cases where this Chapter does not apply

(1) This Chapter (apart from sections 473 and 483) does not apply in relation to an employment-related securities option if, at the time of the acquisition, the earnings from the employment were not (or would not have been if there had been any) general earnings to which section 15 or 21 applies (earnings for year when employee resident and ordinarily resident in the UK).

…

Tax relief on acquisition of option

475 No charge in respect of acquisition of option

(1) No liability to income tax arises in respect of the acquisition of an employment-related securities option.

(2) Subsection (1) is subject to section 526 (approved CSOP schemes: charge where share option granted at a discount).

Tax charge on post-acquisition chargeable events

476 Charge on occurrence of chargeable event

(1) If a chargeable event occurs in relation to an employment-related securities option, the taxable amount counts as employment income of the employee for the relevant tax year.

(2) For this purpose-

(a) 'chargeable event' has the meaning given by section 477,

(b) 'the taxable amount' is the amount determined under section 478, …

(6) This section is subject to—

- section 519 (approved SAYE option schemes: no charge in respect of exercise of share option by employee),
- section 524 (approved CSOP schemes: no charge in respect of exercise of share option by employee), and
- section 530 (enterprise management incentives: no charge on exercise by employee of option to acquire shares at market value).

477 Chargeable events

(1) This section applies for the purposes of section 476 (charge on occurrence of chargeable event).

(2) Any of the events mentioned in subsection (3) is a 'chargeable event' in relation to the employment-related securities option unless it occurs on or after the death of the employee.

(3) The events are-

(a) the acquisition of securities pursuant to the employment-related securities option by an associated person,

(b) the assignment for consideration of the employment-related securities option by an associated person or the release for

consideration of the employment-related securities option by an associated person, or

(c) the receipt by an associated person of a benefit in connection with the employment related securities option (other than one within paragraph (a) or (b).

478 Amount of charge

(1) The taxable amount for the purposes of section 476 (charge on occurrence of chargeable event) is—

AG − DA

where—

AG is the amount of any gain realised on the occurrence of the chargeable event, and

DA is the total of any deductible amounts.

...

(3) Section 480 specifies what are deductible amounts.

480 Deductible amounts

(1) This section applies for the purposes of section 478 (amount of charge on occurrence of chargeable event).

(2) The amount of—

(a) any consideration given for the acquisition of the employment-related securities option, and

(b) the amount of any expenses incurred in connection with the acquisition of securities, assignment, release or receipt which constitutes the chargeable event,

is a deductible amount.

…"

Analysis

18. There is no dispute that, if Chapter 5 of Part 7 of ITEPA applies, there were chargeable events when Mr Charman exercised some of his share options and sold the shares in 2008. Nor is there any dispute that, in that case, the fact that Mr Charman had ceased to be resident in the UK by that time would not prevent the sums realised by him from being charged to tax. Mr Charman contends, however, that Chapter 5 does not apply by virtue of section 474(1) because, "at the time of the acquisition" of the "securities option", that is to say, of the "right to acquire securities", he was resident outside the

UK. Whether this is correct or not depends on whether the options were acquired at the time when they were granted, as HMRC contend, or when they vested, as Mr Charman contends.

19. It is common ground that the resolution of this dispute depends on the proper interpretation of the legislation set out above. It is also common ground that the legislation must be interpreted having regard to its wording, context and purpose.

20. The background to Part 7 was explained by Lord Walker of Gestingthorpe in *Gray's Timber Products Ltd v Revenue and Customs Commissioners* [2010] UKSC 4, [2010] 1 WLR 497 as follows:

> "4. Part 7 of ITEPA 2003 is headed: 'Employment income: income and exemptions relating to securities.' Its provisions reflect three different, and to some extent conflicting, legislative purposes. First there is Parliament's recognition that it is good for the economy, and for social cohesion, for employees to own shares in the company for which they work. Various forms of incentive schemes are therefore encouraged by favourable tax treatment (those in force in 2003 are covered in Chapters 6 to 9 inclusive of Part 7).
>
> 5. Second, if arrangements of this sort are to act as effective long-term incentives, the benefits which they confer have to be made contingent, in one way or another, on satisfactory performance. This creates a problem because it runs counter to the general principle that employee benefits are taxable as emoluments only if they can be converted into money, but that if convertible they should be taxed when first acquired. That principle was stated by Lord Radcliffe in *Abbott v Philbin* [1961] AC 352, 379:
>
> > 'I think that the conferring of a right of this kind as an incident of service is a profit or perquisite which is taxable as such in the year of receipt, so long as the right itself can fairly be given a monetary value, and it is no more relevant for this purpose whether the option is exercised or not in that year, than it would be if the advantage received were in the form of some tangible form of commercial property.'
>
> That was a case about share options, which are now dealt with separately in Chapter 5, but it illustrates the general approach that applied in the days when the taxation of employee benefits was very much simpler than it is now.
>
> 6. The principle of taxing an employee as soon as he received a right or opportunity which might or might not prove valuable to him, depending on future events, was an uncertain exercise which might turn out to be unfair either to the individual employee or to the public purse. At first the uncertainty was eased by extra-statutory concessions. But Parliament soon

> recognised that in many cases the only satisfactory solution was to wait and see, and to charge tax on some 'chargeable event' (an expression which recurs throughout Part 7) either instead of, or in addition to, a charge on the employee's original acquisition of rights.
>
> 7. That inevitably led to opportunities for tax avoidance. The ingenuity of lawyers and accountants made full use of the 'wait and see' principle embodied in these changes in order to find ways of avoiding or reducing the tax charge on a chargeable event, which might be the occasion on which an employee's shares became freely disposable (Chapter 2) or the occasion of the exercise of conversion rights (Chapter 3). The third legislative purpose is to eliminate opportunities for unacceptable tax avoidance. Much of the complication of the provisions in Part 7 (…) is directed to counteracting artificial tax avoidance. There is a further layer of complication in provisions which regulate the inevitable overlaps between different Chapters. It is regrettable that ITEPA 2003, which came into force on 6 April 2003 and was intended to rewrite income tax law (as affecting employment and pensions) in plain English, was almost at once overtaken by massive amendments which are in anything but plain English."

The reference to ITEPA being intended to rewrite the law in plain English is explained by the fact that it was a product of the Tax Law Rewrite project.

21. Further explanation of the background to Part 7 was provided by Lord Reed in *UBS AG v Revenue and Customs Commissioners* [2016] UKSC 13, [2016] 1 WLR 1005 as follows:

> "4. Under ordinary principles of tax law, where an employee receives shares as part of his remuneration, he is liable to income tax on the value of the shares, less any consideration which he may have given for them, in accordance with the decision of the House of Lords in *Weight v Salmon* (1935) 19 TC 174. That case concerned a situation where the managing director of a company had been allowed to subscribe for shares at par as a reward for successful performance. The position where an employee is granted a conditional share option was considered by the House of Lords in *Abbott v Philbin* [1961] AC 352. That was a case where a company's senior employees had been given an option to subscribe for its shares at the then current market price, the option being exercisable at any time within the next ten years. The employees were thus incentivised to increase the company's prosperity. The option was non-transferable and would expire on the employee's death or retirement. It was held that income tax was chargeable on the realisable monetary value of the option at the date of its acquisition, rather than on the value realised when it was subsequently exercised, as the revenue had argued. Lord Reid said, at p 376: 'I can sum up my view by

> saying that conditions and restrictions attached to or inherent in an option may affect its value, but are only relevant on the question whether the option is a perquisite if they would in law or in practice effectively prevent the holder of the option from doing anything when he gets it which would turn it to pecuniary account.'
>
> 5. The decision in *Abbott v Philbin* was reversed by section 25 of the Finance Act 1966 (later consolidated as section 186 of the Income and Corporation Taxes Act 1970), which removed any charge to income tax on the grant of employees' share options, and instead imposed a charge on the gain realised when the option was exercised, assigned or released. Section 78 of the Finance Act 1972 subsequently conferred an exemption from the charge in relation to approved share option schemes, on the view that such schemes could perform valuable social and economic functions."

22. In fact, two points were made by the majority of the House of Lords in *Abbott v Philbin* [1961] AC 352, both of which were subsequently reversed by statute. The first point, and the *ratio decidendi* of the case, is the one referred to by Lord Walker in *Gray's Timber* and by Lord Reed in *UBS* concerning the time at which the option became taxable. I shall return to this below. The second point, which was obiter, was that the difference between the price of the shares under the option and their market value when the option was exercised did not arise "from" the taxpayer's employment. This forms part of the background to the second issue on this appeal. After the earlier legislation referred to by Lord Reed, the relevant provisions were contained in section 135 of the Income and Corporation Taxes Act 1988 ("ICTA 1988"). Subsection (1) addressed the second point, while subsection (2) addressed the first point. Section 135 of the 1988 Act was replaced by the provisions of ITEPA with which the appeal is concerned.

23. Although this history is helpful in understanding the genesis of ITEPA, I accept the submission of counsel for Mr Charman that it is the language of the relevant provisions of ITEPA that matters, and not the slightly different language of the predecessor provisions.

24. HMRC's interpretation of the statutory language is straightforward. Section 420(8) defines a "securities option" as "a right to acquire securities". HMRC contend that this means what it says, and that a right to acquire securities is no less a right if the ability to exercise that right either does not vest for a period of time or is contingent upon some future event. The legislation does not say that the right must be immediately exercisable, and there is no warrant for reading those words in. All that is required is that the employee has a contractual or other legal right, upon whatever terms, to acquire securities.

25. Section 471(1) provides that Chapter 5 applies to a securities option acquired by a person where the right to acquire the securities option is available by reason of an employment of that person. Section 473(1) and section 475(1) provide that no liability to tax arises in respect of the acquisition of an employment-related securities option. Section 473(2) and section 476 provide that tax is charged when there is a chargeable event, chargeable events being those specified in section 477(3). The amount of the

charge is calculated in accordance with section 478(1). Section 480(2)(a) provides that any consideration given for the acquisition of the employment-related securities is a deductible amount for that purpose. HMRC contend that these provisions support the interpretation of "a right to acquire securities" set out in paragraph 24 above. HMRC place particular reliance upon section 480(2)(a) because it will generally be the case that consideration will be given for the acquisition of a securities option when the option is granted, and not when it vests if different.

26. Accordingly, HMRC contend that the effect of section 474(1) is that Chapter 5 does not apply if the employee is non-resident at the time of acquisition of the right to acquire securities interpreted as set out in paragraph 24 above i.e. when the right is granted, not when it vests.

27. HMRC contend that this interpretation of the legislation is supported by three authorities, *Inland Revenue Commissioners v Burton Group plc* [1990] STC 242, *Commissioners of Inland Revenue v Eurocopy plc* (1991) 64 TC 370 and *Commissioners of Inland Revenue v Reed International plc* (1995) 67 TC 552, concerning the question whether option agreements constituted a "right to acquire shares", or amendments to option agreements created a new "right to acquire shares", within section 185(1) of ICTA 1988. Although section 185(1) was concerned with approved share option schemes, it was cross-referred to in section 135(1). Similarly, the provisions with which this case are concerned also cross-refer to the successor provisions to section 185(1): see section 473(4), 475(2) and 476(6).

28. In *Burton Group* Vinelott J held that an option granted subject to the employee performing key tasks set by the employer which could be varied from time to time nevertheless resulted in the employee acquiring "a right to acquire shares" within section 185(1) ICTA 1988 at the date of grant. The Crown accepted that, to the extent that the performance conditions were set when the option was granted, the employee had a right to acquire shares, but contended that it was different if the conditions were imposed subsequently. Vinelott J rejected that contention.

29. In *Eurocopy* the employees' options were originally granted in 1987 on terms that they could only be exercised after the expiry of nine years from the date of grant and lapsed if employment terminated before then. The employer wanted to amend the scheme to enable the employees to exercise the options three years earlier. Mervyn Davies J held that the "right to acquire shares" which the employees would have under the proposed amendment was different to "the right to acquire shares" which they had obtained at the date of grant.

30. In *Reed International* the options granted to employees could only be exercised after the expiry of three years from the date of grant and would lapse on, among other events, termination of employment prior to that date. The employer wanted to amend the scheme in certain respects as a consequence of a merger. As in *Eurocopy*, the question which arose was whether, by virtue of the amendments, the option holders obtained a new and different right to the one they had before. The Court of Appeal answered that question in the negative because the amendments merely effected some very minor improvements to the option holder's existing right. In that context Nourse LJ said at 576:

> "The relevant right for the purposes of paras 29(1) and 25 [of Sch 9 to ICTA 1988] is a right obtained under the scheme to acquire scheme shares. There can be no doubt that under each of the unamended schemes such a right was obtained by each option holder on the grant of his or her option."

31. Counsel for HMRC submitted that, in considering the new provisions, it is permissible and appropriate to consider the case law on the previous legislation, relying on *R (Derry) v Revenue and Customs Commissioners* [2019] UKSC 19, [2019] 1 WLR 2754 at [88]-[90]. He also relied upon the principle that Parliament is assumed to have been aware of that case law when enacting ITEPA: see *Revenue and Customs Commissioners v Embiricos* [2020] UKUT 370 (TCC), [2021] STC 201 at [63]. In my judgment, however, these authorities do not have great weight for present purposes because, even disregarding the fact that the legislation under consideration was the legislation concerning approved share option schemes, the point in issue on this appeal was not in issue in any of those cases. The most that can be said is that the judges in those cases assumed, in the absence of contrary argument, that employees obtained "a right to acquire shares" when an option was granted even if the option was conditional.

32. Mr Charman's case is that, when regard is had to the "general principle" referred to by Lord Walker in *Gray's Timber* at [5] and by Lord Reed in *UBS* at [4], and to the provisions of section 473(1) and section 475(1), it becomes clear that a "right to acquire shares" must be a right that is immediately exercisable.

33. So far as the "general principle" is concerned, counsel for Mr Charman pointed out that, in *Abbott v Philbin*, the option was immediately exercisable although it was not transferable. She submitted that the result would have been different if the option had not been immediately exercisable. I do not accept this. The reasoning of the majority was that the option could be "turned to pecuniary account" (in the words of Lord Watson in *Tennant v Smith* [1892] AC 158 at 159) as soon as it was granted. This was not because it was immediately exercisable, but because it had a financial value which could immediately be realised in one way or another: see Viscount Simonds at 365-366 ("there could be no difficulty in the grantee arranging with a third party that he would exercise the option and transfer the shares to him"), Lord Reid at 371 ("I find nothing to indicate that there would have been much difficulty in finding someone who would have paid a substantial sum for an undertaking by the appellant to apply for the shares when supplied with the purchase money and called upon to exercise the option and thereupon to transfer the shares"), 373-376 and Lord Radcliffe at 378-379 ("he could also at any time, at his choice, sell or raise money on his right to call for the shares"). As all three members of the majority recognised, the fact that the option was not transferable affected the value of the option upon grant, but did not alter the fact that it had some value. This reasoning would be equally applicable to an option which was not yet exercisable, but which could immediately be turned to account in a similar way.

34. The authority which counsel for Mr Charman relied upon most strongly is *RFC 2012 plc v Advocate General for Scotland* [2017] UKSC 45, [2017] 1 WLR 2767. In order to put the passage relied upon into context, it is necessary to quote it together with several preceding paragraphs of Lord Hodge's judgment:

> "41. As a general rule, … the charge to tax on employment income extends to money that the employee is entitled to have paid as his or her remuneration whether it

is paid to the employee or a third party. The legislation does not require that the employee receive the money; a third party, including a trustee, may receive it. While that is a general rule, not every payment by an employer to a third party falls within the tax charge. It is necessary to consider other circumstances revealed in case law and in statutory provisions which fall outside the general rule. Those circumstances include: (i) the taxation of perquisites, at least since the enactment of ITEPA, (ii) where the employer uses the money to give a benefit in kind which is not earnings or emoluments, and (iii) an arrangement by which the employer's payment does not give the intended recipient an immediate vested beneficial interest but only a contingent interest. As I shall seek to show, in the first circumstance, current legislation requires receipt by the employee; in the second circumstance, there are special rules for the taxation of such benefits; and, in the third circumstance, where on a proper analysis of the facts there is only a contingent right, the taxable earnings or emoluments are not paid by the employer as remuneration until the occurrence of the contingency.

42. The first such circumstance is the taxation of 'perquisites and profits' or, in the updated wording of ITEPA , 'any gratuity or other profit or incidental benefit;. Section 131 of ICTA spoke of 'perquisites and profits'. While in colloquial usage a 'perk' may take many forms, judicial interpretation of tax legislation has long required that the perquisite be capable of being converted into money in order to fall within the tax net under this provision. Three cases in the House of Lords demonstrate this. First, in *Tennant v Smith* [1892] AC 150, the House of Lords held that a bank manager was not liable to income tax on the use of accommodation in bank premises in Montrose, which he was required to occupy as part of the duties of his employment, because he could not convert any benefit which he obtained from such occupation into money. The arrangement saved the bank manager from incurring expenditure on accommodation; but that was not enough to make the benefit taxable as an emolument.

43. In *Abbott v Philbin* [1961] AC 352 a majority of the House of Lords held that an employee of a company was liable to income tax on the grant by his employer of an option to purchase shares in that company in the tax-year in which the option was granted because the option itself had a monetary value which the employee could realise. Lord Radcliffe described the principle in *Tennant v Smith* thus, at p 378: "if [the benefits] are by their nature incapable of being turned into money by the recipient they are not taxable, even though they are in any ordinary sense of the word of value to him."

…

45. These judicial decisions gained statutory expression in section 62 of ITEPA which in subsection (2)(b) provides that earnings include 'any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth' and defines 'money's worth' in subsection (3) which looks to the monetary value of the thing 'to the employee' ….

46. A second circumstance, which falls outside the general rule, is where the employer spends money to confer a benefit in kind which the recipient cannot

> convert into money. Such expenditure is not a perquisite or profit, gratuity or incidental benefit for the reasons discussed above and only falls within the income tax regime because of special statutory provision, such as, currently, the 'benefits code' in Part 3, Chapters 2–11 of ITEPA , which cover among others the provision of living accommodation, cars or loans and the payment of expenses. Part 7 of ITEPA also has special rules for shares etc acquired in connection with an employment, and Part 6 of that Act is concerned with income which is not earnings or share-related.
>
> 47. A third circumstance is where the person entitled to receive the sums paid by the employer does not acquire a vested right in those sums until the occurrence of a contingency. This circumstance is illustrated by *Edwards v Roberts* (1935) 19 TC 618, in which an employing company entered into an employment contract to give an employee, in addition to his salary, an interest in a 'conditional fund', into which it would make annual payments from its profits, as an incentive for him to advance the company's interests. The employee was entitled to receive the annual income from the fund but had no right to receive any of the capital of the fund other than that which had been held in the fund for five years or more. The contract provided that he would receive the whole fund if he died while still employed by the company or on termination of his employment by the company in specified circumstances. But the contract also provided that the employee would cease to have any right in the conditional fund in circumstances which included his dismissal for misconduct. The trustees of the fund handed over to the employee the investments in the fund when he later resigned with the consent of the company. The employee argued that the sums which the company had paid into the conditional fund formed part of his emoluments in each of the years in which they were paid into the fund. But the Court of Appeal (Lord Hanworth MR, Romer and Maugham LJJ) held that those sums did not constitute his emoluments in those years because he had only a conditional interest in them; instead the value of the investments transferred to him after his resignation were his emoluments in the tax year in which they were transferred to him. The payments in that year reflected his status as an employee at the time when the contingency was fulfilled. ..."

35. Counsel for Mr Charman relied upon the "third circumstance" identified by Lord Hodge in [41] and explained by him at [47]. She gave as an example of this a case in which an employer promises to pay an employee a bonus of £1000 if the employee remains in employment for one year. The right to payment of the bonus is a contingent right, and tax is only payable if and when the contingency is satisfied. She submitted that the same principle applied to a contingent share option.

36. Counsel for HMRC did not dispute that the law was as stated by Lord Hodge. Nor did he dispute that the result in the case of the bonus example would (subject to anything emerging from the precise terms of the agreement) be as counsel for Mr Charman stated. As he pointed out, however, Lord Hodge gave the "special rules" in Part 7 of ITEPA as an example of his "second circumstance" in [46]. It is those "special rules" which must be applied in the present case, and not the general rule represented by Lord Hodge's "third circumstance".

37. Starting from the premises that (i) the general rule is that a contingent right to a financial benefit is not taxable, but (ii) *Abbott v Philbin* established that a right to acquire shares

which was immediately exercisable was taxable upon grant (and not when it was exercised), counsel for Mr Charman submitted that, interpreted in the light of section 473(1), section 475(1) ITEPA reversed proposition (ii), but not proposition (i).

38. For the reasons given above, I do not accept either of the premises of this submission. To recapitulate: the general rule is displaced by the special rules in Part 7; and *Abbott v Philbin* did not establish that an option was taxable upon grant because it was immediately exercisable, but because it had a value which could immediately be realised.

39. Nor do I accept that sections 473(1) and 475(1) have the effect for which counsel for Mr Charman contended. She submitted that section 473(1) recognised that, but for the exemption contained in section 475(1), tax would be payable in accordance with the general rule. It is, however, telling that section 473(1) was not even mentioned in counsel for Mr Charman's skeleton argument for this appeal. I think that the reason for this is obvious. It is clear from the fact that it forms part of the introductory group of sections in Chapter 5, from the fact that it is headed "Introduction to …" and from its wording that section 473 is simply intended to provide helpful signposts to the following provisions, or as Lord Carnwath memorably put it in *R (Derry)* at [10], "to give clear pointers to each stage of the taxpayer's journey to fiscal enlightenment". Moreover, as counsel for HMRC pointed out, section 473(1) refers to "tax that *might* otherwise arise [emphasis added]", not would.

40. Furthermore, read in the context of sections 473 and 477, it is clear that the purpose of section 475(1) is to ensure that, contrary to what the House of Lords decided in *Abbott v Philbin*, no tax is levied when an employee acquires a share option. Instead, tax is levied when there is a chargeable event, following the "wait and see" approach. (This is why Mr Charman does not rely upon section 475(1) as an answer to HMRC's claim.) It does not follow that the employee has not acquired a right to acquire shares within the meaning of the legislation if the right is not immediately exercisable.

41. Finally, there are two further difficulties with Mr Charman's interpretation of the legislation. First, it involves reading words into section 420(8) which are neither present nor implicit. Secondly, counsel for Mr Charman had no answer to HMRC's point about section 480(2)(a) recorded in paragraph 25 above.

42. Accordingly, I conclude that HMRC are right that section 420(8) is to be interpreted in the manner set out in paragraph 24 above. It follows that the UT's decision on issue 1 was correct.

Issue 2: Did Mr Charman acquire the Axis Capital Restricted Shares "as a director or employee"?

43. It is common ground that, if Mr Charman acquired the Axis Capital Restricted Shares "as a director or employee", then a tax charge arose under section 427 ITEPA when the restrictions were lifted in September 2005, even though Mr Charman was no longer UK resident, because he was UK resident when he obtained his beneficial interest in them in October 2002. The issue is whether Mr Charman acquired the Axis Capital Restricted Shares "as a director or employee", that is to say, "by reason of" his employment by Axis Specialty. There is no dispute that Mr Charman acquired the Axis Specialty Restricted Shares by reason of his employment by Axis Specialty, but as noted above

Mr Charman contends that he acquired the Axis Capital Restricted Shares by reason of his shareholding in Axis Specialty and not by reason of his employment.

The legislation

44. The version of ITEPA that is applicable to this part of the case is ITEPA as originally enacted. Section 422(1)(a) provides that Chapter 2 applies where "a person … acquires a beneficial interest in shares in a company as a director or employee of that or another company". Section 423(1)(a) provides that a person acquires an interest in shares "as a director or employee" if that person acquires the interest "in pursuance of a right conferred on, or opportunity offered to" that person "by reason of" their office as director or employment.

The FTT decision

45. The FTT decided that Mr Charman acquired the Axis Capital Restricted Shares by reason of his employment for the following reasons:

> "313. The Appellant relied on the *Abbot v Philbin* and *Wilcock v Eve* cases but we consider that these cases can easily be distinguished because:
>
> (1) They consider tax arising on the exercise of share options, which, for common law purposes, is accepted as having a source other than employment; being the extraneous factors which have impacted the value of the shares underlying the option.
>
> (2) We accept that these cases suggest the need for a relatively tight nexus between the sum received and the employment which gave rise to that sum, but this is in part because the question asked in those cases is whether the value which is giving rise to the tax (the gain on the exercise of the option) derives from the employment, to which the answer is no. That is not the case for the shares which Mr Charman received as part of the share for share exchange which merely represent a change in form of an existing asset (the Axis Specialty shares) into another asset (the Axis Capital shares) of the same economic value.
>
> (3) It is accepted that 'borderline cases' are likely to be difficult because there is more than one operative cause of the taxable income; that is the case here, but in our view the ultimate cause (or source) is Mr Charman's employment with Axis Specialty.
>
> 314. To suggest that a share for share exchange can break the nexus between shares which are emoluments and turn them into shares which are derived from a different source seems to us an overly mechanistic approach to the law, and to result in a rather

surprising conclusion which provides a very ready loophole for anyone wishing to avoid tax on their employee shares.

315. The point was succinctly put in *Wilcock v Eve* referring back to the judgment of Neill LJ

> 'The question is, was the payment an emolument from the employment? In other words, was the employment the source of the emolument' [p14]

In our view the only realistic response to this question in respect of the Axis Capital shares in yes.

…

317. … Despite the fact that the Axis Specialty shares were cancelled on or immediately after the exchange …, that does not in our view mean that Mr Charman has divested himself of his rights as an employee to shares; those rights were represented initially in the form of the Axis Specialty shares and as a result of the re-capitalisation have changed form to become rights to the Axis Capital shares, but only in a very formalistic sense have Mr Charman's rights been altered. In our view the essential purpose of a … share for share exchange is to ensure that existing shareholder rights are changed in form but not in substance, as reflected by the usual UK tax treatment of such transactions (which … is referred to in the Offering Memorandum).

318. If further support for this is needed, the documents which reflect the changes in the existing Share Option Plans support this, the Agreement of 31 December 2002 between Axis Specialty and Axis Capital transfers the obligation to issue shares under the Plan from Axis Specialty to Axis Capital and the amendments made to the Axis Speciality Long-Term Equity Plan reflect this."

The correct approach on appeal

46. The FTT's decision that Mr Charman acquired the Axis Capital Restricted Shares by reason of his employment can only be challenged by Mr Charman on the ground that the FTT erred in law. The correct approach to such an appeal was described by Mummery LJ in *Kuehne + Nagel Drinks Logistics Ltd v Revenue and Customs Commissioners* [2012] EWCA Civ 34, [2012] STC 840 at [34]:

> " … these appeals are confined to questions of law: it was for the judge in the FTT, entrusted by statute with the judicial function of finding the facts, to consider all the relevant documents and oral evidence and to make findings of primary fact and proper inferences of fact, to which he then had to apply the tax legislation, as interpreted by the courts. It follows that it is not the task of the UT, or of this court, to re-decide or second guess the primary facts, their proper function being limited to

> questions of law, such as whether the FTT misinterpreted the law, or misapplied it to the facts, or made perverse findings of fact unsupported by any evidence, or reached a conclusion that was plainly wrong."

There are numerous other authorities to the same effect.

Analysis

47. There was little, if any, dispute between the parties as to the correct test to be applied to determine whether an interest is acquired "by reason of" employment. It is not necessary for HMRC to show that the interest was acquired by reason *only* of employment. Nor is the test a "*causa sine qua non*" or "but for" test. The test that has found favour in subsequent authorities (see *Mairs v Haughey* [1992] STC 495 at 525 (Hutton LCJ (NI)), *Wilcock v Eve* [1995] STC 18 at 29 (Carnwath J) and *Vermilion Holdings Ltd v Revenue and Customs Commissioners* [2021] CSOH 45, [2021] STC 1874 at [45]-[46] (Lord Campbell of Alloway dissenting) and [69] (Lord Doherty)) is that stated by Oliver LJ in *Wicks v Firth* [1982] 1 Ch 355 at 371:

> "One is directed to see whether the benefit is provided by reason of the employment and in the context of these provisions that, in my judgment, involves no more than asking the question 'what is it that enables the person concerned to enjoy the benefit?' without the necessity for too sophisticated an analysis of the operative reasons why that person may have been prompted to apply for the benefit or to avail himself of it."

48. Counsel for Mr Charman drew a distinction between what she called "linear" cases (in which one interest replaces another) such as *Abbott v Philbin* and what she called "convergent" cases (in which an interest is acquired for more than one reason) such as *Wicks v Firth*. Despite the eloquence of her submissions, I do not find this a helpful distinction. The statutory test must be applied to a wide range of circumstances. As Oliver LJ made clear, the exercise is one which requires an evaluation by the tribunal of fact. In making that evaluation it is not appropriate for the tribunal to try to pigeonhole cases into categories. Particular caution is required before placing reliance upon *Abbott v Philbin* when that case not only involved different statutory language, but also has been reversed by statute.

49. The question is whether the FTT applied the correct legal test. Counsel for Mr Charman submitted that the FTT's reasoning showed that the FTT had wrongly applied a "but for" test. She also submitted that the FTT had misunderstood and misapplied the "source" test articulated by Neill LJ in *Hamblett v Godfrey* [1987] STC 60 at 71 (a case involving the question whether emoluments arose "from" employment) and had wrongly held that a share for share exchange could not, as a matter of law, turn the shares into ones derived from a different source.

50. It is fair to say that the FTT did not direct itself that the test to be applied was that stated by Oliver LJ. Nor did it expressly state that the test was not a "but for" test. Furthermore, I would accept that asking whether the employment is the "source" of the benefit in question may not always be helpful. It does not follow that the FTT erred in law, however.

51. The FTT recognised that there was more than one operative cause of the taxable income. It found that the ultimate cause was Mr Charman's employment with Axis Specialty. It considered that the effect of the share for share exchange was that Mr Charman's rights as an employee had changed in form but not substance. It found support for its view in the amendments to the contractual documents which transferred the obligation to issue shares from Axis Specialty to Axis Capital and provided (among other things) that the restrictions applied to the shares in Axis Capital.

52. I agree with the UT that the FTT did not apply a "but for" test. Nor did it err in law in any other way. Its reasoning was entirely consistent with the application of Oliver LJ's test. It is clear that, had it asked itself, "what is it that enabled Mr Charman to enjoy the Axis Capital Restricted Shares?", the answer it would have given would have been that it was Mr Charman's employment by Axis Specialty. Furthermore, the FTT was entitled to take that view. It is true that, as counsel for Mr Charman emphasised, non-employee shareholders in Axis Specialty benefited from the exchange while employees who were not shareholders did not benefit; but it is also true that, as counsel for HMRC submitted, the reason why Mr Charman was amongst those who benefited was that he had been awarded shares in Axis Specialty by virtue of his employment. That is why Mr Charman's shareholding in Axis Capital was subject to employment-related restrictions whereas shares held by non-employees would not have been restricted. As counsel for HMRC pointed out, the economic value which is charged to tax under Chapter 2 of Part 7 of ITEPA is the value which arises from the lifting of such employment-related restrictions.

53. I consider that the FTT was justified in taking into account the risk of tax avoidance if the contrary conclusion were reached. I do not think that the FTT made the mistake of saying that a share exchange could never lead to a situation where the resultant shares were not enjoyed by reason of employment. The position might perhaps be different if, for example, the share exchange came about as a result of a contested take-over of the employer some years after the employee received shares in the employer. Even then, it would be necessary for the tribunal carefully to consider all the relevant circumstances.

Conclusion

54. For the reasons given above I would dismiss this appeal.

Lord Justice Snowden:

55. I agree.

Lord Justice Green:

56. I also agree.