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Case No: CA-2023-000974

CA-2023-000990

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
MR JUSTICE MELLOR AND JUDGE SWAMI RAGHAVAN
[2023] UKUT 00073 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 19/07/2024

Before:

LADY JUSTICE ASPLIN
LADY JUSTICE WHIPPLE
and
LADY JUSTICE FALK

Between:

**THE COMMISSIONERS FOR HIS MAJESTY'S
REVENUE AND CUSTOMS**

Appellants

- and -

HFFX LLP

Respondent

And Between

(1) STEPHAN ATKINS
(2) YURI BEDNY
(3) PAUL BEREZA
(4) ALEXANDER GERKO
(5) PHILIP HOWSON
(6) RENAT KHABIBULLIN
(7) JOSHUA LEAHY
(8) JACOB METCALFE
(9) ALEX MIGITA
(10) DMITRY SHAKIN
(11) ANDONIS SAKATIS
(12) CHRISTOPHER SHUCKSMITH
(13) EVGENY TANHILEVICH

Appellants

- and -

**THE COMMISSIONERS FOR HIS MAJESTY'S
REVENUE AND CUSTOMS**

Respondents

Kevin Prosser KC and David Yates KC (instructed by **Macfarlanes LLP**) for **HFFX** and the
Individual Appellants

Thomas Chacko and James Kirby (instructed by **HMRC Solicitor's Office and Legal
Services**) for **HMRC**

Hearing dates: 9 and 10 July 2024

Approved Judgment

This judgment was handed down remotely at 2.00pm on 19 July 2024 by circulation to the parties or their representatives by e-mail and by release to the National Archives.

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Lady Justice Falk:

Introduction

1. These appeals concern incentivisation arrangements put in place in October 2010 when GSA, an investment management business, transferred its high frequency foreign currency trading team to a limited liability partnership called HFFX LLP (“HFFX”). HFFX’s business was to second members of the team to GSA Capital Partners LLP (“GSACP”), GSA’s primary trading entity.
2. As a result of the restructuring, members of the team who were made members of HFFX became treated for tax purposes as self-employed partners rather than as employees. Under the arrangements with GSA their overall “pay-out” from the profits they earned for GSA was also increased, but a substantial proportion of it was deferred. The deferral was achieved via a “Capital Allocation Plan” (or “CAP”), under which 50% of the pay-out that the team would otherwise have received was allocated to a corporate member of HFFX, GSA Member Ltd (“GSAM”). GSAM invested those amounts in funds managed by GSA. On the first, second and third anniversaries of the allocation GSAM sold a third of the investments that it had acquired and contributed the net proceeds back to HFFX as “Special Capital”. GSAM then decided to reallocate the Special Capital to individual members, who were able to withdraw it.
3. The hoped-for tax analysis was that GSAM would be taxed at corporation tax rates on the amounts allocated to it (rather than the higher income tax rates to which individual members would be subject if the profits were allocated to them) and that the subsequent reallocation of Special Capital would not give rise to tax for the individual members.
4. The tax issues raised by the appeals are as follows:
 - a) Whether the allocation of profits to GSAM should be considered to be an allocation to the individual members under s.850 of the Income Tax (Trading and Other Income) Act 2005 (“ITTOIA”) (the “s.850 issue”). Strictly, this dispute is between HFFX and HMRC because it concerns the partnership tax return, although the substantive tax consequences are for the individual members.
 - b) If the answer to the s.850 issue is no, whether the individual members are taxable on the reallocation of Special Capital to them either as:
 - i) miscellaneous income under Chapter 8 of Part 5 of ITTOIA (“the miscellaneous income issue”); or
 - ii) sales of occupation income under Chapter 4 of Part 13 of the Income Tax Act 2007 (“the sales of occupation income issue”).
5. Both the First-tier Tribunal (“FTT”) and the Upper Tribunal (“UT”) found against HMRC on the s.850 issue. Although HMRC obtained permission to appeal on that issue from the UT they accept that this court’s decision in *HMRC v BlueCrest Capital Management LP; Dodd v HMRC* [2023] EWCA Civ 1481, [2024] STC 92 (“*BlueCrest CA*”) is determinative of that issue in favour of HFFX, albeit that HMRC reserve the right to apply for permission to appeal to the Supreme Court in due course. I will therefore not consider the s.850 issue further.

6. The FTT accepted HMRC's arguments on the miscellaneous income issue and the sales of occupation income issue. The UT dismissed the individual members' appeal on the miscellaneous income issue and (although it was not necessary for its decision) also went on to find against the individual members on the sales of occupation income issue. The UT granted permission to appeal on both of those issues but refused it in respect of two other issues, for which permission was also refused by this court. Following *BlueCrest CA* the individual members maintain their appeal on the miscellaneous income issue and the sales of occupation income issue. HMRC say that *BlueCrest CA* is dispositive of the miscellaneous income issue in HMRC's favour, and accordingly that the individual members' appeal should be dismissed.
7. The court is grateful for the submissions of Kevin Prosser KC and David Yates KC, for HFFX and the individual members, and Thomas Chacko and James Kirby for HMRC. Mr Prosser addressed the miscellaneous income issue and Mr Yates made submissions on the sales of occupation income issue. Mr Chacko led for HMRC but we heard submissions from Mr Kirby on one aspect of the sales of occupation income issue.

Further background facts

8. The high frequency foreign currency trading team comprised a group of individuals who developed high frequency foreign exchange trading strategies which were implemented using automated trading software designed by the team. The team was led by Mr Alexander Gerko, who became HFFX's "Managing Member". Prior to the creation of HFFX the team was employed by GSA Capital Services Ltd ("GSACS"). GSACS also acted as the managing member of GSA's primary trading entity, GSACP.
9. In addition to its individual members HFFX had two corporate members. The first was GSACS, which was labelled in HFFX's Partnership Deed as the "Corporate Member". The second was GSAM, which was labelled as the "Retention Member". GSAM was owned by a Cayman Islands company acting as the trustee of a purpose trust in the form of a Cayman Islands Star Trust. The purpose of the trust was to own GSAM to promote the business of GSACP and HFFX. GSAM's single director was not otherwise connected with HFFX.
10. Following their transfer to HFFX the high frequency foreign currency trading team continued the activities that they had previously conducted as GSACS employees as secondees from HFFX. As part of the restructuring HFFX also became a member of GSACP. In exchange for seconding the team HFFX received a share of GSACP's profits equal to 50% of the profits generated by the team's activities.
11. The UT outlined how the Capital Allocation Plan was intended to work as follows:

"[10] The steps in the CAP in outline were as follows:

 - (1) Mr Gerko calculated a "Pre-Retention Amount" for each individual member of HFFX. In essence, this was an amount that Mr Gerko would have allocated to the member if there had been no deferral scheme.
 - (2) Mr Gerko was required to allocate to GSAM at least 30% of [the] Pre-Retention amount (Clause 10.3(D) of the LLP Deed). In practice the first

£100,000 of each member's profit allocation was made in cash and 50% of the rest was deferred.

(3) Mr Gerko was empowered (with GSACS's consent) to make recommendations to GSAM in prescribed form as to investment of profits paid to it, the contribution of proceeds of such investments to HFFX as Special Capital, and reallocation of Special Capital to other members.

(4) Mr Gerko duly made recommendations. Those reflected the proportions deferred for the various individual members participating in the CAP.

(5) GSAM duly invested profits paid to it and contributed sums as Special Capital. It then reallocated Special Capital to individual members.

(6) Upon reallocation members could withdraw Special Capital. They argue no income tax was payable by them on withdrawal."

12. As already mentioned, in practice GSAM liquidated one third of the investments acquired, contributed the proceeds as Special Capital and then reallocated that capital on the first, second and third anniversaries of the profit allocation to it. The amount that GSAM was able to invest was also obviously net of the corporation tax that it was required to pay on its profits.
13. Individuals who left HFFX as "bad leavers" were not eligible for a reallocation of Special Capital, but "good leavers" could be given the status of "Restricted Member" to enable them to do so. There was also a separate provision for "Restricted Fund Shares" as an alternative to the CAP, but this was intended for use by US taxpayers only, on the basis that they would be subject to an excessive tax burden if they used the CAP.

The HFFX Partnership Deed

14. The recitals to the Partnership Deed record that:

"The Partnership has been established in order to enable certain former employees of the Corporate Member, each being members of the HFFX Trader Group (defined below), to exercise greater autonomy over their compensation; to provide the opportunity for promotion to partner status within the Partnership and to facilitate internal governance rights for the HFFX Trader Group."

The business of the Partnership is described in clause 4 as being to "second Members to GSA...to assist GSA in carrying on the GSA Business".

15. Clause 10 deals with profit allocations. Clause 10.2 provides that the Managing Member (i.e. Mr Gerko) would determine allocations in accordance with clauses 10.3-10.5 and determine what proportion of the amounts allocated should be capable of being withdrawn under clause 11.
16. Under the heading "Principles of allocation", clause 10.3 provides an order of priority. The first in order is an initial allocation to the Corporate Member, the second is an allocation to individual members reflecting certain permitted drawings and the third, in

clause 10.3(C), is to a retention account of the Corporate Member in respect of anticipated contingencies, the relevant amount being “such amount of profits (if any) as shall in the opinion of the Managing Member acting in good faith be required to be retained in the Partnership” for such purposes. The fourth reads as follows:

“(D) Fourthly... there shall be allocated to the Retention Member an amount equal to the higher of:
(1) 30% of the Pre-Retention Amount for all Individual Members; or
(2) such other amount as the Managing Member may determine for purposes of incentivisation of Members or as may be required by applicable law or regulation.”

In practice the percentage allocated was 50%.

17. The last two allocations are covered by clauses 10.3(E) and (F). Clause 10.3(E) allocates 90% of the balance of the profits to individual members in such proportions as the Managing Member determines, and clause 10.3(F) allocates the remainder to individual members in accordance with their partnership shares.
18. The “Pre-Retention Amount” is essentially defined as:

“... such sum as the Managing Member would potentially have allocated to such Member in any financial year of the Partnership pursuant to clauses 10.3(E) and 10.3(F) had there been no allocation to the Retention Member pursuant to clause 10.3(D)...”

The definition goes on to clarify that:

“For the avoidance of doubt, no individual Member shall have any right or entitlement to or interest in any Pre-Retention Amount. Such sum shall be calculated by the Managing Member solely for the purpose of calculating the allocation to the Retention Member under clause 10.3(D) and shall be confidential to the Managing Member.”

19. Clause 11 covers drawings and distributions. It also provides, at clause 11.9, for Special Capital. Clause 11.9(A), entitled “Contribution of Special Capital”, provides:

“Any of the Members may with the prior agreement of the Managing Member, and the Retention Member shall at the direction of the Corporate Member, make further contributions of capital...in cash or in specie (“Special Capital”)... Any contributions of Special Capital that are made to the Partnership pursuant to this clause 11.9(A) shall be credited (in the case of an in specie contribution, in the amount agreed between the relevant Member and the Managing Member) to the relevant Member’s Special Capital Account and shall be subject to the provisions as to withdrawal and reallocation set out in this clause 11.9...”
20. After providing that such sums might be invested at the discretion of the Managing Member (assets acquired being “Investment Assets”) clause 11.9(A) goes on to provide that amounts allocated to a Special Capital Account “shall be held exclusively for the

benefit of the relevant Member”, and any income arising would also be allocated to the distribution account of that member.

21. Clause 11.9(C), headed “Reallocation of Special Capital”, provides:

“Subject to the provisions below, any Member who for the time being has Special Capital credited to his Special Capital Account (provided that such Special Capital has remained in such Member’s Special Capital Account for at least one month) may, in his sole and absolute discretion, decide that all or part of the interest of such Member in any Special Capital (and accordingly in any Investment Assets acquired with such Special Capital) should be reallocated to any other Member or Members...so that such other Member or Members will, following such reallocation, become beneficially entitled to the relevant part of such Special Capital (and the relevant part of any Investment Assets acquired with such Special Capital and any proceeds of the realisation of any such Investment Assets) and shall give notice of any such decision to the Managing Member. On the making by any Member of any reallocation there shall be a deemed transfer of the relevant proportion of the Special Capital used to acquire the relevant Investment Assets and the amount of Special Capital deemed transferred shall be deducted from the Special Capital Account of the Member that contributed the same and shall be credited to the Special Capital Account of the Member to which such Special Capital has been reallocated.

Within 30 days of the making of an allocation of profit to the Retention Member under clause 10.3(D), the Managing Member may, with the prior consent of the Corporate Member, make recommendations in writing to the Retention Member in the form set out at Schedule 6 as to the investment of such profit (after meeting tax and other liabilities) in shares in the Funds, the contribution of the proceeds of such shares into the Partnership as Special Capital and the reallocation of such Special Capital to other Members. Following the making of such recommendations, the Managing Member may notify each Member of the fact that a recommendation has been made in respect of them in the form set out at Schedule 7. The Managing Member may make further or alternative recommendations to the Retention Member from time to time with the prior consent of the Corporate Member. For the avoidance of doubt, the Retention Member shall be under no obligation to follow the recommendations of the Managing Member and shall have absolute discretion as to how it applies any profit allocations it receives from the Partnership.”

22. The ordering of the provisions in clause 11.9 is somewhat counterintuitive. What the second paragraph of 11.9(C) addresses is the initial allocation under clause 10.3(D), whereas the first paragraph addresses the steps intended to be taken over the following three years when Special Capital was being reallocated.
23. The pro forma letter to the directors of GSAM in Schedule 6 sets out recommendations as to investment of the profit allocation to GSAM (net of tax and expenses) in shares in GSA funds, their sale on the first, second and third anniversaries, contribution of the proceeds as Special Capital and reallocation after one month to named individual members in specified proportions. The letter points out that recommendations may be

amended, refers to the provisions of clause 11.9(B) (see below) and states that reallocations to persons who had ceased to be members would not be possible, in which event reallocation to the Corporate Member was recommended.

24. The pro forma letter to individual members attached as Schedule 7 is headed “Notification of Potential Award under HFFX LLP Capital Allocation Plan”. This outlines the purpose of the Capital Allocation Plan to incentivise members and in simple terms how it would work. Under the sub-heading “Your Potential Award” the letter goes on to confirm that “the Partnership has made a recommendation to [GSAM] that you should receive an Award” and that it has recommended that it be “reallocated to you” from GSAM’s Special Capital. Details of the “Award” are set out, using a band rather than a specified figure (for example, \$500,000 to \$1,000,000), together with the proposed three-year period for “vesting”, the funds in which the amount will be invested in the interim and the mechanism for Special Capital to be acquired by GSAM, reallocated to the individual and then become available for withdrawal. The addressee is warned in the following terms:

“The Partnership may make further recommendations or may modify its recommendations to the Retention Member to take into account such matters relating to your performance or conduct or the performance of the Partnership or GSA or other events or circumstances in subsequent years as it is required to take into account under any law, regulation, rule, order or directive (including, without limitation, any regulation, rule or order of the FSA) applicable to the Partnership, GSA or any Member (whether in their capacity as Member or as Seconded of GSA).

In certain limited circumstances, set out at clause 11.9(B) of the Deed, [GSAM] shall be restricted from reallocating Special Capital to you, in which case the value of the Award shall be reduced in common with potential awards for all other members of the Partnership, on a pro rata basis.”

The addressee is also warned that reallocation will not occur if (broadly) the individual is a bad leaver.

25. Clause 11.9(D) permits a member to whom Special Capital is allocated to withdraw it on 14 days’ notice.
26. Clause 11.9(B) imposes a restriction on the power to reallocate under clause 11.9(C). It enables the Corporate Member to prevent GSAM reallocating under that clause other than to the Corporate Member, broadly up to the amount of certain liabilities incurred or likely to be incurred as a result of a breach of duty by a member of the HFFX team, or in circumstances where there is a loss. The power is stated to be exercisable “At any time prior to the reallocation under clause 11.9(C)” and to the extent that “the Corporate Member may determine in its discretion, acting in good faith”.

Miscellaneous income: s.687 ITTOIA

27. The key charging provision in Chapter 8 of Part 5 of ITTOIA is s.687. It materially provides:

“687 Charge to tax on income not otherwise charged

(1) Income tax is charged under this Chapter on income from any source that is not charged to income tax under or as a result of any other provision of this Act or any other Act.
...”

28. The statutory predecessor of s.687 was Schedule D Case VI, and earlier authorities that consider Schedule D Case VI may be relevant: see the discussion in *BlueCrest CA* at [97] and [98].
29. It is not disputed that the amounts reallocated to the individual members were income in the hands of the individual members. The central issue in this case is whether that income had a source.

The decision in *BlueCrest CA*

30. *BlueCrest CA* concerned a “Partner Incentivisation Plan” or “PIP” that has material similarities to the CAP operated by HFFX. It too concerned a partnership (in fact three partnerships) with a corporate member to which profits were allocated as part of incentivisation arrangements and which acquired “Special Capital”. In that case the corporate partner immediately reinvested the profits (net of tax) in Special Capital and the relevant investments were made at that stage. However, as in this case (see [20] above), assets representing Special Capital were held “exclusively for the benefit of the relevant Member” and so were beneficially owned by the member holding the Special Capital rather than being partnership assets (see the discussion at *BlueCrest CA* at [30] and [48]). The clause dealing with reallocation, set out at [32] in *BlueCrest CA*, is materially similar to the first paragraph of clause 11.9(C) of the Partnership Deed in this case. Deferral periods for the BlueCrest PIP were initially six months but were increased to up to three years. Further, unlike this case individuals were informed of the amount of their “provisional” award, as opposed to what band it would fall in.
31. The leading judgment in *BlueCrest CA* was delivered by Sir Launcelot Henderson. After determining the s.850 issue against HMRC, he turned to the miscellaneous income issue from [95] onwards. I will not repeat his analysis of the statutory background to s.687 ITTOIA and his consideration of the authorities at [97] to [104], other than to note his important conclusion at [102] that, as is implicit in the wording of s.687(1), the income must arise from an identifiable source in the relevant tax year. That was a point that had previously been left open.
32. In *BlueCrest CA* there were two questions to determine in relation to s.687, first whether the reallocation of Special Capital gave rise to income rather than capital in the hands of the recipients, and secondly whether the corporate partner’s decision to make the award amounted to a “source”. The first of these points, considered at [113] to [118] and decided in HMRC’s favour, is not in issue here.
33. On the question of source, Sir Launcelot Henderson referred to the UT’s consideration of the earlier UT decision in *Spritebeam Ltd v Revenue and Customs Comrs* [2015] UKUT 75 (TCC), [2015] STC 1222 (“*Spritebeam*”) and the Court of Appeal’s decision in *Cunard’s Trustees v IRC, McPheeters v IRC* (1945) 27 TC 122, [1946] 1 All ER 159 (“*Cunard*”) and then went on to consider *Cunard* in more detail (using the Tax Cases page numbering). He said this:

“[121] In *Cunard*, the trustees of a will were directed to hold the residuary estate of the testatrix on trust to pay the income to her sister during her life, with power to supplement the income from capital if the income alone was insufficient to enable the sister to live in the same degree of comfort as she had during the testatrix’s lifetime. This power was exercised by the trustees, and the sister was then assessed to income tax under Case III of Schedule D and to surtax on the whole of the payments made to her, including the supplements from capital. The main argument for the taxpayer was that ‘the payments in question, having been made out of capital at a time when the residue had not been ascertained, were not [*her*] taxable income’: see 130-131. The leading judgment was delivered by Lord Greene MR, with whom Morton and McKinnon LJ agreed. After holding that the will, properly construed, authorised the application of capital in this way from the date of the testatrix’s death, and not merely from the date when the administration of the residuary estate was completed, Lord Greene continued, at 132:

‘The payments, therefore, in my opinion, were properly made and at the moment of payment became income of the recipient, Miss McPheeters ... [*her*] title to the income arose when the trustees exercised their discretion in her favour and not before. *At that moment a new source of income came into existence* [my emphasis]. The payments came to Miss McPheeters under the express terms of the will and not by virtue of what I may call the quasi-interest enjoyed by a residuary legatee pending completion of administration ...’

[122] Lord Greene went on to deal with further arguments that the payments were not taxable under Case III of Schedule D because (a) they were not annual payments, and (b) they were discretionary and therefore voluntary payments which the taxpayer could not claim as of right (see 133). The answer to the first point was that the payments were capable of recurrence on a yearly basis, even if they varied in amount, while the second argument also failed for the reasons which Lord Greene gave at 133-134:

‘It was suggested, however, that the Rule does not extend to mere voluntary payments. But the payments here were of a totally different character. They were not voluntary in any relevant sense, but were made in the exercise of a discretion conferred by the will out of a fund provided for the purpose by the testatrix. It is true, of course, that the trustees had an absolute discretion whether to make a payment or not. But the question whether they should do so is one which they were bound to take into their consideration. ... The money, when received by Miss McPheeters, was received by her through the joint operation of the will and the exercise of their discretion by the trustees.’

[123] *Cunard* was relevantly a case about Case III of Schedule D, but there is no reason to suppose that what Lord Greene said is not equally capable of application for the purposes of Case VI or section 687. I therefore see no difficulty in holding that a source for the final PIP awards may be found in the exercise by the corporate partner of its discretion whether or not to follow the recommendations of the Board and make the awards, especially as it is

common ground that the discretion was not unfettered and had to be exercised in accordance with the principles of the *Braganza* case.”

34. Sir Launcelot Henderson then endorsed a distinction made by the UT in that case between a withdrawal of partnership capital and the PIP, on the basis that in the case of the PIP there was a separate stage before withdrawal, namely the exercise of a discretion by the corporate partner. The individuals had “no right to withdraw their Special Capital unless the Corporate Partner made a decision to re-allocate it to them and made their PIP Awards final”. He concluded at [125] that, for all these reasons, the source requirement was met.

The *Braganza* principle

35. Sir Launcelot Henderson’s reference to *Braganza* at [123] is to *Braganza v BP Shipping Ltd* [2015] UKSC 17, [2015] 4 All ER 639. The essence of what is now commonly referred to as the *Braganza* principle is that a contractual discretion may be subject to an implied term that the discretion is exercised rationally.
36. The context in *Braganza* was a decision by an employer that an employee had committed suicide and was thereby excluded from death in service benefits, and the relevant issue was the approach that needed to be taken in reaching that decision. Baroness Hale, with whom Lord Kerr agreed, said this at [18]:

“Contractual terms in which one party to the contract is given the power to exercise a discretion, or to form an opinion as to relevant facts, are extremely common. It is not for the courts to rewrite the parties’ bargain for them, still less to substitute themselves for the contractually agreed decision-maker. Nevertheless, the party who is charged with making decisions which affect the rights of both parties to the contract has a clear conflict of interest. That conflict is heightened where there is a significant imbalance of power between the contracting parties as there often will be in an employment contract. The courts have therefore sought to ensure that such contractual powers are not abused. They have done so by implying a term as to the manner in which such powers may be exercised, a term which may vary according to the terms of the contract and the context in which the decision-making power is given.”

37. Baroness Hale then drew an analogy with the court’s approach in reviewing decisions of a public authority. As Lord Hodge picked up at [52] and [53], what was required was a rationality review, applying *Wednesbury* principles. Like Baroness Hale, Lord Hodge noted the significance of the employment context as well as the nature of the particular decision (at [54] onwards). He said at [57] that in the context of bonuses where there were no specific criteria, the courts had decided that the employee is entitled to a “bona fide and rational exercise by the employer of its discretion”, with “little scope for intensive scrutiny of the decision-making process”. In contrast, a fact-finding determination such as the one in issue in *Braganza* justified greater scrutiny. Lord Neuberger (and Lord Wilson) agreed with the other members of the court on this point at [103].
38. One of the bonus-related cases referred to by Lord Hodge was *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287, [2005] ICR 402 (“*Horkulak*”). The relevant contract specified that the bonus decision was in the “sole discretion” of Cantor

Fitzgerald's president. Potter LJ, giving the judgment of the court, gave the following explanation at [30]:

“It is pertinent to observe that, in cases of this kind, the implication of the term is not the application of a ‘good faith’ doctrine, which does not exist in English contract law; rather is it as a requirement necessary to give genuine value, rather than nominal force or mere lip-service, to the obligation of the party required or empowered to exercise the relevant discretion. While, in any such situation, the parties are likely to have conflicting interests and the provisions of the contract effectively place the resolution of that conflict in the hands of the party exercising the discretion, it is presumed to be the reasonable expectation and therefore the common intention of the parties that there should be a genuine and rational, as opposed to an empty or irrational, exercise of discretion. Thus the courts impose an implied term of the nature and to the extent described.”

39. In *Horkulak* the court concluded that, on the facts, the discretion was subject to a requirement to exercise it on a bona fide and rational basis. In reaching that conclusion Potter LJ commented at [46] that:

“...the clause is one contained in a contract of employment in a high-earning and competitive activity in which the payment of discretionary bonuses is part of the remuneration structure of employers. In this case, the objective purpose of the bonus clause on the evidence...was plainly to motivate and reward the employee in respect of his endeavours... Further, the condition precedent that the employee should still be working for CFI and should not have given notice or attempted to procure his release, demonstrates that the bonus was to be paid in anticipation of future loyalty. In such a case, as it seems to me, the provision is necessarily to be read as intended to have some contractual content, i.e. it is to be read as a contractual benefit to the employee, as opposed to being a mere declaration of the employer's right to pay a bonus if he wishes, a right which he enjoys regardless of contract.”

40. The *Braganza* principle has also been considered in the context of profit sharing in an LLP. In *Reinhard v Ondra LLP* [2015] EWHC 26 (Ch), [2016] 2 BCLC 571 an investment banker who was summarily dismissed from an LLP brought proceedings which included claims in respect of his alleged partnership share. Warren J considered that decisions taken regarding Mr Reinhard's bonus (qua member) and about whether his profit share should be increased were subject to an obligation to exercise the discretion in good faith and rationally: see at [412], [447] and [457].
41. It must be right that the *Braganza* principle can in principle be applied where an individual works in a business as a member of an LLP rather than as an employee. Although the focus in *Braganza* was on employment, the relevant considerations, in particular a “significant imbalance of power” and reliance on discretionary remuneration arrangements, may well be present.

Miscellaneous income: discussion

42. Despite Mr Prosser's able attempts to persuade us otherwise, I have concluded that HMRC are correct that this case is materially indistinguishable from *BlueCrest CA* and that we should therefore dismiss the individual members' appeal.
43. Mr Prosser's submissions had the following principal strands:
- a) In order for there to be a source of income for s.687 ITTOIA purposes the taxpayer must have a legal right to receive the income, whereas the individual members at no stage had a right to receive the Special Capital. Further, the existence of any *Braganza*-type obligation is insufficient.
 - b) Another way of expressing this is that the taxpayer must "possess" the source. That requirement is said to be apparent from case law and legislation, and to cast light on what is meant by "source".
 - c) If these points are wrong and the existence of a "fettered" discretion exercised in the recipient's favour is sufficient, then the proper interpretation of the Partnership Deed is that the discretion to reallocate Special Capital is unfettered, in contrast to the position in *BlueCrest CA* where it was common ground that the *Braganza* principle applied.
 - d) Activities cannot, without more, give rise to a source. There has to be a right to the income. (This was not an issue raised in *BlueCrest CA*.)

It can be seen that the primary argument is that, for s.687 ITTOIA to apply, there must be a legal right to receive the relevant income.

Must there be a legal right?

44. Mr Prosser relied on Sir Launcelot Henderson's reference at [102] of his judgment in *BlueCrest CA* to the need for a source in the relevant tax year and on what he said at [121] to [123], set out above. Mr Prosser submitted that the conclusion at [123] that a source "may be found in the exercise by the corporate partner of its discretion" amounted to a rejection of HMRC's argument that a *Braganza*-type obligation regarding the manner of exercise of a discretion was sufficient. Further, the reason for the conclusion was that the exercise of the discretion conferred a contractual entitlement to receive Special Capital in that case, whereas it did not in this case.
45. I accept that *BlueCrest CA* does not support the proposition that the existence of a *Braganza*-type obligation is sufficient without more. But I cannot accept that the conclusion that s.687 ITTOIA applied in that case was dependent on the exercise of the discretion conferring an enforceable legal right to the transfer of Special Capital. Rather, what was held to be sufficient to create a source was the exercise by the corporate partner of its discretion to reallocate Special Capital in the context of a legal agreement which conferred certain rights on the individual members. At no stage did Sir Launcelot Henderson say that the decision had to give rise to an enforceable legal right to have Special Capital transferred, and I do not consider that any such right must be taken to be read into his reasoning.

46. As Sir Launcelot Henderson explained, the main argument in *Cunard* was that the payments were made out of capital at a time when the residue had not been ascertained. In the passage cited in *BlueCrest CA* at [121] Lord Greene MR was explaining that the amounts became income at the moment of payment and that Miss McPheeters' "title", and the relevant source, arose when the trustees exercised their discretion in her favour. In deciding that the receipts were income – which is what this passage of his judgment addresses – Lord Greene was not saying, and did not need to say, that the exercise of the trustees' discretion gave rise to an enforceable legal right. There was simply no discussion of whether (for example) the trustees could have altered their decision prior to payment in the event that they had reason to do so. Rather, what Lord Greene went on to emphasise was the fact that the payments were made under the express terms of the will.
47. In considering the separate question of whether the payments were voluntary, Lord Greene observed that they "were not voluntary in any relevant sense", because the trustees were bound to consider whether to exercise their discretion, and that the money was received "through the joint operation of the will and the exercise of their discretion by the trustees" (see *BlueCrest CA* at [122], above). So the focus there was also not on the decision to pay turning something that was voluntary into something that conferred an enforceable right to payment. Rather, the combination of the terms of the will and the exercise of the trustees' discretion meant that the payments were not to be regarded as voluntary.
48. Mr Prosser relied on the earlier House of Lords decision in *Drummond v Collins* [1915] AC 1011. In that case non-UK resident trustees of a discretionary will trust exercised their discretion to pay income to the testator's minor grandchildren. The children's mother was assessed to tax as their guardian under Schedule D Case V (income from foreign possessions). Her argument that the mere exercise of a discretion did not create a foreign possession failed. Mr Prosser relied on Lord Wrenbury's statement at p.1020 that as soon as the discretion was exercised the resulting payment was "a payment of income to which the child is entitled by virtue of the gift made by the testator" and that the child's interest became "vested" rather than contingent at that point. Mr Prosser also relied on Lord Parker's use of the language of entitlement and his reference to the money being held "in trust" for the children "as soon as the trustees had exercised their discretionary trust" (pp.1018-1019).
49. Earl Loreburn (with whom Lord Atkinson, Lord Parker and Lord Sumner all concurred) expressed the position slightly differently. At p.1017 he referred to the payments as:

"...not voluntary payments in any relevant sense. They were payments made in fulfilment of a testamentary disposition for the benefit of the children in the exercise of a discretion conferred by the will."
50. As in *Cunard*, I do not read the House of Lords decision in *Drummond v Collins* (or that of the Court of Appeal in that case, [1914] 2 KB 643, to which we were also taken) as addressing the precise nature of the "entitlement" acquired when the discretion was exercised. Rather, what was critical was the children's interests under the terms of the will in combination with the exercise of the trustees' discretion in their favour. Both components were essential.

51. In contrast, in *Stedeford (Inspector of Taxes) v Beloe* [1932] AC 388, the Rev. Beloe was held not to be taxable on a series of payments made to him following his retirement as headmaster of a school under a power conferred on the school's governing body under its charter. The critical difference was that the payments were "a mere voluntary gift" which depended on "somebody else's goodwill" (per Viscount Dunedin at p.390). While the charter permitted pension payments to be made, that was pursuant to a power conferred on the governing body to apply income for "such purposes as in their absolute discretion they may deem to be for the benefit of the college". Effectively, the beneficiary was the school rather than anyone else, including retired staff.
52. This can be contrasted with the right of a discretionary beneficiary under a trust to be properly considered as a potential recipient and to have their interest protected by a court by compelling due administration (see *Snell's Equity*, 34th ed. at 22-005 and *Gartside v Inland Revenue Commissioners* [1968] AC 553 at pp.617-618). Unlike the beneficiaries in *Cunard* and *Drummond v Collins* the Rev. Beloe had no rights at all under the charter. That meant that there could be no source. A decision to make a payment to him could not create a source in the absence of the additional legal framework present in both *Cunard* and *Drummond v Collins*.
53. Mr Prosser also relied on *Brocklesby v Merricks* (1934) 18 TC 576, a decision of Finlay J upheld by the Court of Appeal, and the decision of Rose J in *Manduca v HMRC* [2015] UKUT 262 (TCC), [2015] STC 2002. In *Brocklesby v Merricks* an architect arranged an introduction which led to the purchase of an estate by a client through a company. He later contracted with the company to work on a sale of the estate in return for a share of the profit. He did very little work but duly received his agreed share. An assessment to tax under Schedule D Case VI was upheld. Finlay J commented at p.582 that anything paid for the initial introduction would have been "a perfectly voluntary payment and would not be income; it would be merely a present". However, the Special Commissioners had found that the payment the architect subsequently received was made for services rendered, and it did not matter that the architect had done very little: it was a "contract for remuneration in respect of services rendered", and it made no difference that it was very advantageous. The sum was paid because the architect had an enforceable right under a contract for services, rather than it being something given for a "purely voluntary service" (p.583).
54. *Manduca v HMRC* concerned the tax treatment of an amount paid in settlement of a claim for failure to pay an agreed bonus to employees of a hedge fund manager who had been made redundant. It was common ground that the settlement amount should have the same tax treatment as the bonus would have had. HMRC's assessment under Schedule D Case VI was upheld, on the basis that the bonus was remuneration for services provided under a binding contract, akin to profits or gains falling within other Cases of Schedule D. Rose J accepted at [35] the submission for HMRC that:

"...once it is established that the payment was an income receipt rather than a capital receipt and that it was paid pursuant to a binding contract in return for some kind of service then there is no need to go further to inquire into the extent of the services in fact provided."
55. *Brocklesby v Merricks* and *Manduca v HMRC* are consistent with earlier case law. In *Scott v Ricketts* [1967] 1 WLR 828 Lord Denning MR relied on Rowlatt J's judgment in

Ryall v Hoare [1932] 2 KB 447 in saying at p.831 that Schedule D Case VI included remuneration for services rendered but not gratuitous payments.

56. I do not consider that these cases establish that an enforceable right to a payment is required. They do establish that a payment of an income nature made under a contract in return for a service can be sufficient to bring the sum within the charge to income tax under what is now s.687 even if the service is a limited one, but they do not tell us that a charge cannot arise in any other circumstances which involve something more than a pure gift.
57. I also reject Mr Prosser's effective attempt to distinguish *BlueCrest CA* on the facts on this point. The wording of the first paragraph of clause 11.9(C) of the Partnership Deed is materially similar to the wording considered in *BlueCrest CA*: see [30] above. Both refer to deciding to reallocate and to notification of that decision, but it is natural for them to do so. The real focus, however, is on the act of reallocation and the legal consequences of that, rather than on the decision itself. There is nothing to indicate that the decision gave rise to an enforceable legal right under the BlueCrest PIP but not in this case.
58. In particular, I do not accept the suggestion that GSA's power under clause 11.9(B) to prevent a reallocation to individual members in certain circumstances makes any difference, any more than an ability of trustees to change their minds for good reason after taking a decision to pay income to a discretionary beneficiary would do so. In circumstances where a decision is made pursuant to a legal framework of the kind considered in *Cunard* and *BlueCrest CA* under which the recipient has a right to be considered, the possibility of the decision being altered before it is implemented does not affect the fact that a reallocation or payment that actually is made has its source in the decision to make it.
59. Further, it would be extraordinary if a payment or reallocation made without a clearly distinguishable anterior decision risked being treated differently to a payment made after an identifiable decision to do so, with only the latter being treated as having a source. It might be that a change of mind without good reason following a decision to make a payment or reallocation would be more susceptible to an irrationality challenge (or a claim for breach of a trustee's duties) than in other circumstances, but it is likely to be no more than that.
60. Mr Prosser drew attention to comments by the UT in its decision in *BlueCrest* ([2022] UKUT 200 (TCC), [2022] STC 1696) about the way in which "provisional awards" were made under the BlueCrest PIP, including a statement about individual members being given reassurances that they would not lose them except in specified circumstances and a suggestion in the language used by the UT in that case that a right may have been created when a decision was made to make a final award. However, as was pointed out in *BlueCrest CA* at [63], the UT's comments on this topic did not "fully reflect the FTT's more nuanced findings", and in any event what is now material is the reasoning of this court in that case.
61. As Mr Prosser accepted, the submission that there must be a legal right to receive the relevant income in order to fall within s.687 ITTOIA necessarily involves arguing that *Spritebeam*, one of the cases referred to in *BlueCrest CA*, was incorrectly decided. In that case interest on a loan from company A to company B was payable (in the form of shares) to company C, which had no rights under the loan agreement. The UT held that the

interest was nonetheless taxable in C's hands under Schedule D Case VI on the basis that B's obligation to pay provided the necessary connection between the source and the recipient. I do not need to comment further on *Spritebeam*, beyond making clear that all that is required to dispose of this case is to decide that the contractual arrangements in the Partnership Deed, together with the reallocation process, gave rise to income in the hands of the individual members, as it did under the BlueCrest PIP. It is not necessary to go further and, for example, consider the precise limits of the requirement for a connection between the source and the income considered in *Spritebeam*.

62. In summary at this point, and subject to Mr Prosser's further arguments considered below, the case law does not establish that s.687 can apply only if there is a legally enforceable right to the relevant payment. Rather, the decisions taken in favour of individual members to reallocate Special Capital, in combination with their rights under the Partnership Deed which provided the legal context for the decisions, are capable of amounting to a source from which the receipt of the Special Capital was derived. That combination can be sufficient to mean that what is received is not a pure gift, and is taxable under s.687.

Possession

63. Mr Prosser further submitted that a source of income must be something that the taxpayer "possesses". Applied to this case, no source could exist unless the decision to reallocate conferred an entitlement to receive the income.
64. Mr Prosser relied on *Bray (Inspector of Taxes) v Best* [1989] 1 WLR 167, a case concerning employment income, where Lord Oliver said at p.303:

"It is a well established principle deriving from the nature of income tax as an annual tax, that a receipt or entitlement arising in a year of assessment is not chargeable to tax unless there exists during that year a source from which it arises... The principle is conveniently expressed in *Whiteman and Wheatcroft on Income Tax*, 2nd ed. (1976), p. 21, paras. 1-28, as follows:

'most types of income are classified by reference to the source from which they come. From this it was held to follow that if a taxpayer ceased to possess a particular source of income, he could not be taxed on delayed receipts from that source unless these were referable to, and could be assessed in respect of, a period during which he possessed the source.'

65. Mr Prosser also referred to a statement of Park J in *Pumahaven Ltd v Williams* [2002] STC 1423 at [20], in a case about assessment and postponement, although my reading of that decision is that Park J was at that stage reciting argument and in fact left open whether a source (and thus possession of it) was required. Mr Prosser further took us to some references to acquiring or possessing a source of income in past and present legislation.
66. I do not find any of these references to be of particular assistance. The concept of possessing a source of income may be useful in some contexts. The most obvious is to explain why income either is or no longer is within a particular head of charge to tax, the latter alternative being the one discussed in the extract from *Whiteman and Wheatcroft* to which Lord Oliver referred. Common examples would be the charges to tax on trading

and property letting income, where specific provision is needed to ensure that tax is charged on receipts arising after the activity has ceased or been disposed of, albeit that current income tax legislation makes no reference to any concept of possession in that context: see Chapter 18 of Part 2 and Chapter 10 of Part 3 of ITTOIA.

67. The legislative examples that we were shown take the matter no further. Examples in previous legislation that referred to “possess” or used similar language generally related to Schedule D Cases III, IV and V, which charged to tax income from debt instruments and foreign possessions. References to possessing the relevant source make sense in that context, but shed no real light on the issue that we have to decide.

Was GSAM’s discretion unfettered?

68. Mr Prosser submitted that the proper interpretation of the Partnership Deed is that GSAM’s discretion to reallocate under clause 11.9(C) is unfettered. The first paragraph refers expressly to “sole and absolute discretion” and there is another reference, “for the avoidance of doubt”, to absolute discretion at the end of the second paragraph. In contrast, other provisions in the Partnership Deed do not specify that a discretion is absolute and/or expressly require powers to be exercised in good faith. Clause 11.9(B) is an example of a good faith obligation, as is clause 10.(3)(C) (see [16] and [26] above). Further, clause 11.9(C) is a provision that allows any member to reallocate Special Capital, not just GSAM, which Mr Prosser submitted is inconsistent with any *Braganza* obligation. Mr Prosser also submitted that the absence of any provision limiting GSAM’s liability, in contrast to clause 14.8 which expressly limits the Managing Member’s liability where he acts in good faith, is indicative of there being no scope for GSAM to be liable. The purpose trust on which GSAM’s shares were held also meant that there was no need to fetter GSAM’s discretion under clause 11.9(C), because the purpose trust would ensure that value was not inappropriately diverted.
69. I do not find these points persuasive. The application of the *Braganza* principle to the relevant clause in the BlueCrest PIP, which also referred to sole and absolute discretion, was appropriately common ground. Like the PIP, the HFFX CAP was designed as an incentivisation arrangement, as the Partnership Deed and pro forma letters attached to it make clear and as the FTT found. Although not strictly an employment context the context is sufficiently close for similar considerations to apply, as Warren J accepted in *Reinhard v Ondra*.
70. GSAM’s sole role is to operate the CAP. Profits are allocated to it for that purpose under clause 10.3(D) explicitly by reference to the Pre-Retention Amount, which is the amount that each individual member would have received absent a deferral. GSAM has no other right to share in profits. It is also obvious that the aim of clause 11.9 is to provide the mechanism for GSAM to invest the amounts received in GSA funds, reinvest the proceeds in due course by way of Special Capital and then reallocate the Special Capital, precisely as the pro forma letters attached to the Partnership Deed contemplate, and for individual members then to be able to withdraw it. That mechanism is expressly contemplated by the second paragraph of clause 11.9(C), which cross-refers to the letters. The CAP is analogous to the bonus arrangements discussed by Potter LJ in *Horkulak* ([39] above).
71. The fact that the wording of the first paragraph of clause 11.9(C) might technically be wide enough to allow members other than GSAM to reallocate Special Capital does not

mean that GSAM would be subject to no duty as to how its own discretion should be exercised, given the broader context and the obvious aim of the provisions. Reallocation by an individual member also seems highly unlikely: reallocation may only be to another member of HFFX rather than to (say) a family member, and in any event the whole point of reallocation to an individual is to facilitate access by them to their deferred reward in short order. If GSAM had not played the part expected of it for some irrational reason then the individual members who had received letters in the form set out in Schedule 7, and who had continued to work for up to three years in the expectation of their deferred reward, would not only complain but would have a legitimate basis to do so. It is not enough to say, as Mr Prosser suggested, that they could walk away from the business. That would also have been the case in *Horkulak*.

72. The nature of the warnings in the pro forma letter set out at [24] above are worth noting. The addressee is given the clear impression that an award will only be held back or reduced in specified circumstances, namely regulatory requirements, the application in “limited circumstances” of clause 11.9(B) or where they are a “bad leaver”, the most obvious examples of which are misconduct or joining a competitor.
73. As Mr Chacko rightly submitted, the pro forma letter in Schedule 7 forms part of the Partnership Deed and must be taken into account when construing it.
74. The fetter that is reflected in the *Braganza* principle is hard to remove. *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200, [2013] BLR 265 was a case relating to a contract between an NHS trust and a service provider which allowed the trust to deduct amounts for service failures. Reversing the decision of the judge below, this court concluded that there was no need to imply a term fettering the trust’s power on the facts because the express contractual provisions effectively addressed the issue. However, Jackson LJ considered other pre-*Braganza* authorities and said at [83]:

“An important feature of the above line of authorities is that in each case the discretion did not involve a simple decision whether or not to exercise an absolute contractual right. The discretion involved making an assessment or choosing from a range of options, taking into account the interests of both parties. In any contract under which one party is permitted to exercise such a discretion, there is an implied term. The precise formulation of that term has been variously expressed in the authorities. In essence, however, it is that the relevant party will not exercise its discretion in an arbitrary, capricious or irrational manner. Such a term is extremely difficult to exclude, although I would not say it is utterly impossible to do so...”

75. I also do not accept that the different wording relied on by Mr Prosser in other provisions of the Partnership Deed assists the individual members. The express good faith obligations relate to the limited circumstances in which profits need to be retained to meet contingencies which (presumably) have not already been taken into account in determining partnership profits (clause 10.3(C)) or to satisfy liabilities arising from a breach of duty or a loss (clause 11.9(B)). It is not surprising that, when agreeing the terms of the Partnership Deed, it was considered desirable to spell out that this power was to be a restricted one. It does not follow that all other discretions may be exercised in bad faith or irrationally. Further, the limitation on liability in clause 14.8 makes obvious sense

for an individual such as Mr Gerko, whereas there is no indication that GSAM would hold assets apart from those related to the CAP.

76. Mr Prosser's reliance on the purpose trust on which GSAM's shares are held also does not meet the point. GSAM's shareholder is not a party to the Partnership Deed so the continued application of the trust is not guaranteed, but more fundamentally its existence provides no comfort to an individual member that the amount effectively earmarked for them will not be allocated to another individual or otherwise used for the benefit of the wider business.
77. In summary, therefore, the individual members had rights under the Partnership Deed to a proper exercise of GSAM's discretion to reallocate, in accordance with the *Braganza* principle.

Whether activities can give rise to a source

78. The question whether a payment made in return for some activities or services can fall within s.687 independently of a contractual framework did not arise for consideration in *BlueCrest CA*, and since it is not necessary to consider it here I will not do so.

Summary

79. In summary on the miscellaneous income issue, the individual members' rights under the Partnership Deed, combined with decisions taken in their favour to reallocate Special Capital, amounted to a source from which the receipt of the Special Capital pursuant to those decisions was derived. The receipt is accordingly taxable under s.687 ITTOIA.

Sales of occupation income

80. Although HMRC requested that we decide the sales of occupation income issue, as in *BlueCrest CA* it is not necessary to do so in order to dispose of the appeal. In that case Sir Launcelot Henderson expressed the view, with which Lewison LJ and I agreed, that it would be unwise to consider it but that we should not be taken to endorse the reasoning below. Those points apply equally in this case. It is not appropriate to discuss this issue further.

Conclusion

81. In conclusion, both HMRC's appeal on the s.850 issue and the individual members' appeal should be dismissed.

Lady Justice Whipple:

82. I agree.

Lady Justice Asplin:

83. I also agree.