TC02752

Appeal number: TC/2011/07080

INCOME TAX – self assessment return – appeal against closure notice with amendments – whether employment- related security option – yes - whether Income Tax (Earnings and Pensions) Act 2003 Part 7 Chapter 5 applies to employer's scheme – yes - whether there was a deductible amount for consideration – no - appeal dismissed – Tribunal procedure - costs under complex track – no "opt out" received from representative- whether appellant potentially liable for HMRC's costs – yes.

FIRST-TIER TRIBUNAL
TAX CHAMBER

MICHAEL PHAIR **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE ALISON MCKENNA
MICHAEL SHARP

Sitting in public at Bedford Square on 4 February 2013

The Appellant appeared in person

Richard Vallat of counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Background

1. Mr Phair was a senior employee of Bear Stearns International Limited ("the Company") in the United Kingdom from May 2000 to January 2004. His remuneration scheme included the allocation of units in the Company's Capital Accumulation Plan ("CAP").

2. In his self assessment return for the tax year 2004/5, Mr Phair's receipts from the CAP were deducted from earnings on the basis that he was non-resident in the UK at the time of distribution. He subsequently reclaimed the PAYE which had been deducted by the Company in relation to the CAP distribution when it was made. HMRC opened an enquiry and issued a Closure Notice including an amendment of return, dated 25 November 2011. The total amount of tax due under the amended return was £1,578,307. However, taking into account the payments already made under PAYE, it required Mr Phair to pay an additional £813,113 for the tax year ended 5 April 2005.

3. The amended return was reviewed by HMRC at Mr Phair's request but by letter dated 31 May 2011 the decision in the Closure Notice was upheld. Mr Phair then lodged a Notice of Appeal with the Tribunal on 17 August 2011. His appeal was thus out of time, but he explained the reason for his delay as that, at the relevant time, he was in Switzerland and his papers were at his representative's office in London so he had to arrange to travel to London to gain access to them. HMRC raised no objection to this appeal proceeding out of time and the Tribunal gives permission for it to do so.

4. The Tribunal was asked by the parties to determine the proper tax treatment of Mr Phair's receipts from the CAP and any deduction due from those receipts, by answering the questions identified as "the issues" by the parties. It was agreed by the parties that the Tribunal would not be asked to determine the precise quantum of tax payable.

5. On the Notice of Appeal form sent to the Tribunal, Mr Phair listed his "representative" for the purposes of rule 11 of The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 ("the Rules") as AG Tax Limited. We note that AG Tax Limited submitted the Notice of Appeal form to the Tribunal with a covering letter on headed paper. It requested acknowledgement of receipt, which the Tribunal duly sent to AG Tax Limited by letter dated 13 October 2011.

6. Mr Phair's appeal was assigned to the "complex track" under rule 23 of the Rules in view of its complexity and financial value. An appellant whose case is assigned to the complex track may "opt out" of potential liability for HMRC's costs by notifying the Tribunal that he wishes to do so under rule 10 (1) (c) (ii) of the Rules. The Tribunal's file shows that Mr Phair was notified of the assignment of this appeal to the complex track and of the right to opt out of potential liability for costs in a letter sent to his nominated representative dated 13 October 2011. This was the same letter

in which receipt of the appeal was acknowledged, as requested by AG Tax Limited. No response to that letter was received, although the Tribunal's file shows that AG Tax Limited continued to correspond with the Tribunal on Mr Phair's behalf about other matters preparatory to the appeal hearing. At the hearing, Mr Phair submitted that his representative had not received the letter and furthermore that they did not understand the significance of it and so could not have advised him about it in any event. HMRC submitted that the requirements under the Rules for an award of costs to the successful party in this appeal had been satisfied. We give our decision as to costs at paragraph 42 below.

7. At the hearing of the appeal, Mr Phair represented himself, although a representative of AG Tax Limited was in attendance at the hearing. Mr Phair was concerned to assure the Tribunal that he did not seek to avoid any tax lawfully due but merely to establish the proper tax treatment of the CAP distribution by obtaining the ruling of the Tribunal, which he would accept. We, in turn, accept his assurances and thank him for them.

8. We are grateful to both parties to the appeal for their clear written submissions sent in advance of the hearing and for their oral submissions at the hearing itself. We were provided with a bundle of documentary evidence by the Appellant and a bundle of statutory and other materials by HMRC.

The Facts

9. The parties helpfully agreed a statement of facts and issues to assist the Tribunal. The factual background to this appeal was not in dispute. The relevant facts are as follows.

10. Mr Phair was employed by the Company as a senior managing director in the UK from 3 May 2000 to 2 January 2004. Although the title "director" was used, his role did not fall within the legislative definition of the term. In October 2000 Mr Phair signed an election to receive part of his "guaranteed bonus" in the form of units in the CAP. On 29 September 2004 and 18 March 2005 he received distributions from the CAP.

11. Mr Phair was also employed by Bear Stearns International Holdings Limited outside the UK from 3 May 2000 to 2 January 2004, although he was UK resident, UK ordinarily resident, and non-UK domiciled from January 1988. He ceased UK tax residence permanently on 30 March 2004 and has been non-UK tax resident ever since.

12. Mr Phair's terms and conditions of employment, as set out in his service agreement, comprised a £90,000 salary and guaranteed bonuses. The Company offered Mr Phair the opportunity to elect to participate in its CAP, which he did on 16 October 2000. This meant that his future bonuses would be paid in the form of CAP units credited to his Capital Accumulation Account and, following dates specified in the plan, a number of shares of common stock in Bear Stearns Companies Inc equal to

the number of CAP units would be issued to him. Mr Phair elected for an extended payment deferral period of eight years.

13. On 2 April 2004 Mr Phair's employment with the Company was terminated and he left the UK. The circumstances of his termination were such that he retained his rights to the CAP units. On 29 September 2004 and 18 March 2005 Mr Phair received CAP distributions in the form of shares. The Company operated PAYE in relation to those distributions.

14. Mr Phair filed his 2005 self assessment return showing the CAP distributions deducted from his earnings, on the basis that he was not resident in the UK at the time of the distribution. HMRC opened an enquiry which resulted in the closure notice and amendment to assessment currently under appeal.

The Evidence

15. The Tribunal considered carefully the documentary materials before us, and in particular Mr Phair's Service Agreement and the four key documents relating to his participation in the CAP. These were:

(a) The Bear Stearns Companies Inc Capital Accumulation Plan for Senior Managing Directors, for Plan Years beginning on or after 1 July 1999 (tab G);

(b) The Terms and Conditions of CAP Unit Award Granted to Michael Phair under the Bear Stearns Companies Inc. Capital Accumulation Plan for Senior Managing Directors for the years 2000, 2001 and 2002 (tabs J, N and P);

(c) Mr Phair's Initial Plan Election Form (tab F);

(d) The covering letter for the Initial Plan Election Form (tab E).

The Issues

16. It was unclear to the Tribunal whether the parties were agreed that the CAP units were employment-related security options. Mr Phair's Statement of Case made "no comment" on this issue but his skeleton argument referred us to his counsel's opinion to the contrary and asked the Tribunal to confirm the position.

17. The parties specifically asked the Tribunal to determine the following issues:

(a) Does Part 7 Chapter 5 of Income Tax (Employment and Pensions) Act ("ITEPA") apply to options granted before 2003?

(b) Does the Appellant's receipt of CAP units rather than other forms of payment give rise to a deduction under s 480 ITEPA?

The Law

18. ITEPA 2003 Part 7 Chapter 5 (as amended) charges the amount of any gain realised where securities are acquired pursuant to a "securities option". The relevant provisions are as follows.

19. Section 420(8) ITEPA defines a "*securities option*" as "a *right to acquire securities*". Section 471 ITEPA applies chapter 5 to securities options available by reason of employment.

20. Section 477 (3) (a) provides that a "*chargeable event"* occurs, inter alia, when there is an acquisition of securities pursuant to the employment-related securities option and section 478 ITEPA provides that the "*taxable amount"* is "*the amount of any gain realised less the total of any deductible amounts"*.

21. Section 480 sets out the deductible amounts, including:

> (2)(a) any consideration given for the acquisition of the employment-related securities option
>
> (5)(a) any amount that constituted earnings from the employment under Chapter 1 of Part 3 (earnings) in respect of the acquisition of the employment –related securities option (other than an amount of exempt income)

22. Section 421A(3) ITEPA provides that the consideration referred to at s 480(2)(a) above does not include the performance of duties in connection with the employment.

23. Section 474(1) ITEPA exempts from the charge to tax employees who were non resident and not ordinarily resident at the time the option was awarded, but does not provide exemptions for employees who were resident when the option was awarded but no longer resident at the time the option was exercised. Section 476(1) ITEPA provides that in relation to an employment-related securities option, the taxable amount counts as employment income of the employee for the relevant tax year.

24. The predecessor to ITEPA was The Income and Corporation Taxes Act 1988. Section 135 as amended provided for the award of a share option to be tax free but for a charge on the gain realised on the exercise of the option.

The Parties' Submissions on the Issues

(a) The Appellant's Case

25. Mr Phair explained to the Tribunal that he had obtained counsel's opinion on his case but that as it had proven erroneous he had decided to represent himself, with the assistance of AG Tax Limited.

26. In his self assessment return, Mr Phair had treated the CAP units as "conditional securities". However, this argument was not repeated by Mr Phair in his submissions before the Tribunal. HMRC dealt with the point briefly by submitting that Mr Phair's

entitlement under the CAP was a "right to acquire" only and so could not be regarded as a "conditional" or "restricted" interest, because a right to acquire is excluded from the definition of "interest" in s 420 (8) ITEPA.

27. In relation to issue (a), Mr Phair submitted that ITEPA came into force after his CAP units had been acquired and that a plain reading of the legislation showed that it was not intended to cover events which preceded it. By way of example, he drew the Tribunal's attention to s 474 (1) ITEPA, which refers to earnings at the time of the acquisition of the employment-related securities option. Mr Phair submitted that the predecessor legislation had continued to apply to his case.

28. In relation to issue (b), Mr Phair submitted that his entry into the CAP in October 2000 had involved his forfeiture of the right to receive a "contractually enforceable, non-discretionary, quantifiable and pre-determined amount of bonus cash" in return for an entitlement to acquire CAP units. He submitted that this forfeiture constituted "consideration" for the purposes of s 480 (2) ITEPA so that he was entitled to a deduction from the chargeable gain in the amount of the value of the cash bonus he had forfeited. In so doing, he referred the Tribunal to the decisions in *Abbott v Philbin [1961] AC 352* and to *UBS AG v HMRC* [2010] UKFTT 366 (TC). Mr Vallat drew the Tribunal's attention to the Upper Tribunal's decision in the *UBS* case, reported at [2012] UKUT 320 (TCC).

(b) HMRC's Case

29. Mr Vallat, on behalf of HMRC, submitted that Mr Phair's rights under the CAP were clearly rights to acquire securities at a later date and therefore constituted employment-related securities options under ITEPA. He referred the Tribunal to the CAP documentation, which expressly provided that Mr Phair had only the rights of a "general unsecured creditor" and submitted that Mr Phair had plainly acquired no immediate interest in the shares but only CAP points which entitled him to future shares.

30. HMRC also relied upon correspondence between itself and the Company and to a ruling it had issued to the Company in 2005 to the effect that awards under the CAP represented a right to acquire securities and so should be treated as an employment-related securities option. Mr Phair objected to HMRC's reliance before the Tribunal upon a ruling which preceded this appeal and to which he was not a party.

31. Turning to issue (a), HMRC's case was that ITEPA Part 7 Chapter 5 applied to any chargeable event that occurred pursuant to an employment-related securities option after 1 September 2003, regardless of when the option was acquired. Mr Vallat submitted that the legislative scheme was concerned with the occurrence of a chargeable event and not with the date of acquisition of the option. It was further submitted that the inclusion in the legislation of certain transitional provisions (not being relevant to this appeal) indicated that Parliament intended for options acquired before 2003 to be chargeable if a later chargeable event occurred. It was also submitted that it was unnecessary for the legislation to state expressly that it applied

"irrespective of the date of acquisition", as had been submitted by Mr Phair, and that there was no ambiguity in the statutory scheme.

32. In respect of issue (b), HMRC's case was that Mr Phair was not entitled to claim a deduction from the charge to tax under s 480 (2) ITEPA because no "consideration" had been given for the CAP units (the performance of Mr Phair's employment duties being excluded) and neither was s 480 (5) applicable as no amounts had previously been treated as his income in relation to the CAP units.

33. HMRC's case was that Mr Phair had not given up any rights in electing to receive CAP units. In HMRC's submission, the documentation showed that Mr Phair had been given the choice to elect between different remuneration systems and had elected to participate in the CAP. His argument that he had forfeited other forms of remuneration in favour of the CAP units and that the value of the forfeited rights should be treated as consideration for the purposes of s 480 (2) was said to be misconceived. In electing to join the CAP scheme, he had not forfeited an enforceable entitlement to immediate payment of a specific cash award, so that the *UBS* case on which the Appellant sought to rely should be distinguished. Mr Phair's entitlement to a cash bonus was, in HMRC's submission, expressly contingent upon his employment not being terminated for cause. Mr Vallat drew the Tribunal's attention to paragraph [71] of the Upper Tribunal's decision in *UBS*, which made clear that in the case of a contract guaranteeing minimum future bonus payments, an employee was not "entitled" to the bonus until the future date on which he was entitled to the immediate payment of the bonus.

34. Alternatively, HMRC submitted that, if the Tribunal took the view that Mr Phair had given up the right to receive his bonus in cash when entering the CAP, then he had acquired in return not a securities option but merely the right to participate in the CAP. As such, there was no deductible amount attributable to the cost of acquiring the securities option, as required by s 480(2) ITEPA. It followed that the value of the cash bonus would not be the relevant amount to be considered as consideration under the statutory scheme in any event.

35. Finally, for the avoidance of doubt, HMRC submitted that the liability to tax arose at the distribution of the shares in 2004/5 because these were deferred earnings for an earlier period during which Mr Phair was resident and ordinarily resident in the UK. It was therefore irrelevant that he was not UK tax resident in the year of receipt.

Conclusion

36. We have read Mr Phair's Service Agreement carefully. We note that clause 2 provided that on each fiscal year end bonus pay day, he would receive a "guaranteed bonus compensation…payable in the form of cash and non-cash compensation, including stock options and CAP deferral" if he had elected to participate in the CAP. Clause 2 (f) provided that his compensation may at the Company's sole discretion be payable in the form of cash, stock options or other non cash compensation.

37. We have also considered the documents relating to Mr Phair's participation in the CAP. We note that the Bear Stearns Companies Inc Capital Accumulation Plan for Senior Managing Directors defined the "Required Deferral Amount" as one excluding any portion of compensation in respect of which there was an entitlement to immediate payment prior to the Election. We note that under the Terms and Conditions of the CAP Unit Award, Mr Phair was granted a number of units which had prescribed future "vesting dates". It was further provided that, in the event of termination of employment for cause or in the event that he breached certain restrictive covenants, the units should not vest and should be cancelled for no value. The covering letter with Mr Phair's Initial Plan Election Form, which he was required to sign, acknowledged that his sole right against the Company in respect of compensation deferred under the CAP would be that of a general unsecured creditor and that, prior to the receipt of the common stock under the plan, he had no right to deal with the shares. We also had regard to a covering memo dated 27 September 2000 regarding participation in the CAP. This described participation in the CAP as "an election to defer the receipt of compensation that would otherwise be payable in cash in favour of an interest in the Plan."

38. We confirm that in our view, the CAP units are employment-related security options within the meaning of s 471 ITEPA, being, on a plain reading of the documents, a right, available by reason of employment, to acquire securities at a later date rather than being the acquisition of an interest of any sort at the time the CAP units were awarded. In reaching this conclusion we have not relied upon HMRC's 2005 ruling on the Company's scheme, noting that Mr Phair had no input into the evidence and argument upon which it was based and that it does not bind the Tribunal in this appeal.

39. With regard to issue (a), we accept HMRC's submission that ITEPA is properly to be applied to Mr Phair's return, on the basis that the chargeable event provided for in the legislation at s 477 (3) (a) is the distribution of the shares to Mr Phair (which post-dated the legislation) rather than his entry into the CAP (which preceded it). It was not in dispute that Mr Phair was UK tax resident on the date of the chargeable event. It does not seem to us that the statutory scheme is unclear about its intended ambit, as Mr Phair submitted, or that the predecessor legislation should be applied. In view of our conclusion on this point, we do not need to decide what the tax treatment of Mr Phair's income would have been under the predecessor legislation.

40. With regard to issue (b), we agree with Mr Vallat's interpretation of Mr Phair's contractual arrangements, being that he was prospectively (but not immediately) entitled to a bonus only if certain conditions were met. Our conclusion is that Mr Phair elected to receive part of his prospective bonus in the form of CAP units in place of his provisional entitlement to a cash bonus. We follow the Upper Tribunal's approach to the question of "entitlement" in the *UBS* decision as denoting a present right to a present payment. Accordingly, we have concluded that Mr Phair did not have an enforceable right to the cash bonus which he opted out of in favour of joining the CAP. He did not, therefore, give up an "entitlement" to cash in favour of CAP units at the point he made his election.

41. In view of our conclusion that there was no forfeiture of an enforceable right to cash, Mr Phair's submission that he gave consideration (in the form of forfeiture) for the acquisition of the employment-related securities option becomes redundant. We do not, accordingly, need to decide the question of the proper basis for quantifying the deductible amount for consideration under s 480 (2) ITEPA.

42. Our conclusions on the issues before us lead us to dismiss this appeal. We now return to the issue of costs, mentioned at paragraph [6] above. Mr Phair told the Tribunal that he was horrified to learn of his potential liability for HMRC's costs in this appeal. He said that the representative of AG Tax Limited who attended the hearing had told him (and we accept this, although the representative did not give formal evidence) that the letter had not been received and that, looking at a copy of it now, he did not understand it. We note that the letter of 13 October 2011 was not returned as undelivered, and was addressed in the same way as other letters which were answered. We also note that it provided an acknowledgement of the appeal which had been requested when the Notice of Appeal was submitted. The Tribunal's file shows that that acknowledgement had been chased by AG Tax Limited on 20 September but there were no further requests for acknowledgement of receipt after 13 October. We conclude on the balance of probabilities that AG Tax Limited received the letter of 13 October 2011 which notified it of the requirement to "opt out" of the costs regime. As to the failure to appreciate the significance of the letter, the Tribunal must assume that any person (especially a professional person) listed as a representative for the purposes of Rule 11 is able to perform that function in a way which meets the obligations of the overriding objective in rule 2 of the Rules. Under rule 11 (3) the representative must perform the obligations of a party and rule 2 requires the parties to co-operate with the Tribunal generally. We view this as involving an obligation for a representative to familiarise him or herself with the Rules and to refer to the Tribunal's guidance or ask for an explanation if anything is unclear. In these circumstances, whilst we have considerable sympathy for Mr Phair's position, we conclude that the Tribunal's costs jurisdiction is engaged in this case because the representative was duly notified of the allocation of the appeal to the complex track but did not opt out of potential liability for costs on behalf of its client.

43. We now invite HMRC to make a written application for costs, together with a schedule of the costs claimed, in accordance with rule 10 (3) of the Rules, following which the Tribunal will make a further ruling after giving Mr Phair an opportunity to make representations and considering his financial means as required by rule 10 (5).

44. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

ALISON MCKENNA
TRIBUNAL JUDGE

RELEASE DATE: 17 June 2013