TC01291

Appeal number: TC/2009/16970

National Insurance Contributions – Class 1 – payment by employee benefit trust to employee following sale of sponsoring company – whether a "gratuity" – yes – whether the Appellant indirectly allocated the payment to the employee – no – whether payment made indirectly by the Appellant – no – Social Security (Contributions) Regulations 2001/1004, Regulation 5 – payment disregarded in calculating earnings – Channel 5 TV Group Limited v Morehead considered – appeal allowed

FIRST-TIER TRIBUNAL

TAX

KNOWLEDGEPOINT 360 GROUP LIMITED **Appellant**

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS (NIC) **Respondents**

TRIBUNAL: **KEVIN POOLE (TRIBUNAL JUDGE)**
SUSAN STOTT FCA, CTA

Sitting in public in Manchester on 13 and 14 June 2011

Sadiya Choudhury, instructed by Knight & Sons LLP for the Appellant

Colin Williams, Presenting Officer of HMRC for the Respondents

DECISION

Introduction

1. This appeal concerns the liability of the Appellant to account for primary and secondary class 1 National Insurance Contributions ("NICs") in relation to cash payments made to one of its employees in October 2003 and February 2004. The payments were made by the trustees of an employee benefit trust following an earlier sale of the shares in Gardiner-Caldwell (Holdings) Limited ("Holdings"), the parent company of the Appellant's group of companies.

2. The law relating to NICs on such payments was changed with effect from shortly after the second of these payments so the significance of this case is to some extent historical.

The facts

Preliminary points

3. HMRC and the Appellant were helpfully able to agree a statement of facts, which forms the basis of our findings of fact, and is set out in full below.

4. We also heard oral evidence from Stephen Angrave ("Mr Angrave") the Managing Director of Holdings and of the Appellant, William Gardiner ("Mr Gardiner"), the chairman of Holdings, Stephen Roxborough ("Mr Roxborough"), Operations Director of the Appellant and director of Holdings and Vivien Adshead ("Mrs Adshead"), a senior employee of the Appellant (all as at the relevant time).

5. It was the payments made to Mrs Adshead in 2003-04 which were the subject of this appeal, though it was agreed that this was a representative case, whose outcome would be taken to determine the NIC treatment of the payments made to all the other employees in that year and in 2002-03.

6. The agreed statement of facts reads as follows (with some italic annotations which we have added in the light of evidence at the hearing):

> "STATEMENT OF FACTS
>
> 1. Knowledgepoint 360 Group Limited ("the Appellant") is the successor company *[in fact, it was established at the hearing that it is the same company, having simply changed its name]* of Gardiner-Caldwell Communications Limited ("Communications") *[the Appellant]*, which was the main operating company of the Gardiner-Caldwell group of companies ("the Group"), whose holding company was Gardiner-Caldwell Holdings Limited ("Holdings").
>
> 2. In 1992, an employee benefit trust known as the Gardiner-Caldwell Employee Trust ("No. 1 Trust") was set up for the benefit of the employees of Communications. Until 28 December 2001, the trustee of

the No. 1 Trust was known as Gardiner-Caldwell Trustee Limited, which was a 100% subsidiary of Holdings.

3. In 1997, a second employee benefit trust known as the Gardiner-Caldwell Employee (No. 2) Trust ("No. 2 Trust") was set up, also for the benefit of employees of Communications. Until 28 December 2001, the trustee of the No. 2 Trust was Gardiner-Caldwell Trustee (No. 2) Limited, which was also a 100% subsidiary of Holdings.

4. The major difference between the two Trusts was that the No. 1 Trust excluded from the class of beneficiaries all persons who would cause section 13(1) Inheritance Act 1984 not to apply to a disposition by the Trust. No such exclusion of beneficiaries was made by the No. 2 Trust.

5. In the summer of 2001, Thomson Healthcare plc ("Thomson") entered into negotiations with Holdings for the purchase of Holdings' entire share capital. It was agreed during these negotiations that the Trusts would cease to be associated with the Group and their funds would not be under the control of the Group or Thomson. *[In fact, the initial position of Holdings in the negotiations was that the Trusts would be included but Thomson at first rejected this, saying it was a "complication too far". It then sought effectively to reverse this position in the draft documents produced by its lawyers and a final compromise was reached, as set out in 6 below.]*

6. On 28 December 2001, the entire issued share capital of Holdings was acquired by Thomson for consideration in cash and loan notes of approximately £39 million. Prior to this purchase, the following steps were carried out:

(a) the power to appoint new trustees in respect of both Trusts was vested in their respective trustees and was no longer vested in Holdings;

(b) on 6 December 2001, the shares in the two trustee companies were transferred to the joint names of Mr Dennis Hall, consultant to the firm of solicitors acting for the share sellers, and Mr William Gardiner, the then chairman of Holdings; and

(c) the trustees of both Trusts covenanted not to make any distributions without first informing the board of Communications of their intention to do so and consulting with a majority of members of that board as to the proposed distribution. *[The precise wording in the relevant deed was as follows: "The First/Second Trustee covenants not to make any distribution from the First/Second Trust without first informing the board of directors of the Company ("the Board") in writing of the proposed distribution and consulting in good faith with a majority of the members of the Board as to the proposed distribution."]*

7. The names of Gardiner-Caldwell Trustee Limited and Gardiner-Caldwell Trustee (No. 2) Limited were changed to The George Scheme Limited and The David Scheme Limited respectively on 8 February 2002. The directors of both these trustee companies from 4 December 2001 were Mr Gardiner, Mr Hall, Mr Stephen Angrave and Mr Stephen Roxborough. The No. 1 Trust and the No. 2 Trust are now commonly referred to as "the George Scheme" and "the David Scheme" respectively after the change of names of their respective trustees even though the names of both Trusts remained the same as before. *[The name changes were done in order to emphasise the split away from the Appellant.]*

8. On 28 December 2001, Mr Gardiner resigned as a director and chairman of Holdings and three non-executive directors were appointed at the request of Thomson. Mr Angrave and Mr Roxborough continued in their positions as directors of Holdings.

9. In May 2002, Mr Gardiner resigned as a director of both The George Scheme Limited and The David Scheme Limited and was appointed a trustee of both Trusts. *[This was connected with his emigration from the UK for tax purposes, in connection with which he was advised to resign all directorships of UK companies; he was effectively able to continue his involvement as before by becoming instead a trustee of both trusts.]*

10. As a result of the sale of the share capital to Thomson and the exercise of share options by employees prior to the sale, there was a large amount of cash in the two Trusts. The trustees decided to make cash payments to those employees who had contributed to the success of the Group prior to its sale to Thomson.

11. In October 2002, the No. 1 Trust made a payment to beneficiaries who had been employees of Communications on 28 December 2001 and satisfied certain criteria. Its trustee, The George Scheme Limited, paid £144,978.51 secondary class 1 national insurance contributions (NIC's) in respect of this payment. The No. 2 Trust also made a payment in November 2002 in respect of which its trustee, The David Scheme Limited, paid £18,861.71 secondary class 1 NICs. Income tax and primary Class 1 NICs were also deducted from both payments.

12. The trustees of both Trusts claimed repayment of the secondary Class 1 NICs they had paid in respect of these sums by letters sent to HM Revenue and Customs ("the Respondents") on 30 March 2005.

13. The No. 1 Trust made two further payments during the period 6th April 2003 to 5th April 2004: one in October 2003 and the other in February 2004. Income tax was deducted from both these payments. No deduction was made in respect of primary and secondary Class 1 NICs in respect of the payments made between 6th April 2003 and 5th April 2004.

14. One of the beneficiaries to whom payments were made from the No. 1 Trust was Mrs Vivian Adshead, who was the director of commercial operations of Communications.

15. On 13 November 2009, the Respondents issued a decision under section 8 of the Social Security Contributions and Benefits Act 1992 in respect of the payments made by the No. 1 Trust to Mrs Adshead, as a representative employee of the Appellant, during the period 6th April 2003 to 5th April 2004. According to this decision, the Appellant had paid primary and secondary Class 1 NICs equal to £*[amount redacted]* in respect of Mrs Adshead's earnings for this period. The Respondents contend that the Appellant was actually liable to pay the sum of £*[amount redacted]* in respect of those earnings. The difference between these two figures, £*[amount redacted]*, was the sum of primary and secondary Class 1 NICs the Respondents contend the Appellant was liable to pay in respect of the payments to Mrs Adshead from the No. 1 Trust during the period.

16. The Appellant appealed this decision to the Tribunal on 1 December 2009 and contends that it was not liable to pay any NICs in respect of the payments received by Mrs Adshead from the No. 1 Trust during the period in question.

17. If the Appellant's appeal is upheld, it contends that it is also entitled to a refund of the secondary Class 1 NICs paid the trustees in respect of the payments made to beneficiaries between 6th April 2002 and 5th April 2003, equal to a total of £163,840.22.

18. If the Respondents' decision in upheld in respect of the payments to Mrs Adshead, the Appellant will not only be unable to claim this refund but will also be liable to pay primary Class 1 NICs of £46,040.94 and secondary Class 1 NICs of £194,986.65 in respect of the total payments made by the No. 1 Trust to beneficiaries between 6th April 2003 and 5th April 2004, giving rise to a total liability of £241,027.59 in respect of this period."

7. More background was given in the witness statements and oral evidence, particularly of Mr Angrave. We find the following facts.

The establishment of the No. 1 Trust – terms, background and purpose

8. The No. 1 Trust was established by a trust deed dated 7 March 1992 ("the No. 1 Trust Deed"), which contained the following recital:

> "The Company wishes to establish this Trust as an employees' share scheme to act as an incentive for its officers and employees and intends to pay to the Trustees the sum of £100 to be held in accordance with the terms of this Trust and from time to time further money, investments or other property may be paid or transferred to the Trustee by way of addition"

9. The No. 1 Trust Deed was in fairly standard form, establishing a discretionary trust for the benefit of the Appellant's employees (past, present and future). It contained the following key provisions:

> "2. TRUSTS
>
> 2.1 SUBJECT to the provisions of clause 3 below, the Trustee shall hold the Trust Fund and the income thereof upon such trusts for the benefit of the Beneficiaries or any one or more of the Beneficiaries exclusive of the other or others in such shares and proportions and (where appropriate) subject to such terms and limitations and with and subject to such provisions for maintenance education or advancement or for forfeiture in the event of bankruptcy or otherwise and with such discretionary trusts and powers exercisable by such persons as the Trustee shall from time to time by deed or deeds revocable or irrevocable executed before the Distribution Date but without infringing the rule against perpetuities appoint BUT SO THAT the Trustee shall have power from time to time before the Distribution Date (but without infringing the said rule) to pay or apply the whole or any part or parts of the unappointed capital of the Trust Fund to or for the benefit of such one or more of the Beneficiaries as are for the time being living in such shares as the Trustee in its absolute discretion shall think fit without the necessity for a deed or deeds.
>
> 2.2 IF there is any question as to whether an individual is a Beneficiary, and in particular any question of whether a person is an employee or former employee of the Company, the Trustee shall refer the question to the Board of Directors or a duly authorised designated Committee of the Board of Directors of the Company whose written determination of the point shall be final and binding.
>
> 2.3 NOTWITHSTANDING any other provisions of this Deed, any property which is comprised in the Trust Fund shall not be applied for the benefit of any person for whose benefit the trusts could not permit it to be applied without Section 13(1) of the Inheritance Tax Act 1984 (5% plus participators) thereby failing to apply to such disposition or payment AND PROVIDED THAT it shall not be applied in such a way as to cause this Trust to cease to be an Employees' Share Scheme as defined in Section 743 of the Companies Act 1985.
>
> 2.4 SUBJECT as aforesaid the Trustee shall have the following powers exercisable at any time before the Distribution Date:
>
> 2.4.1 power from time to time by deed naming the individual concerned to include in the Beneficiaries any individual except any individual who may for the time being be excluded from the Beneficiaries in exercise of the power in that behalf contained in sub-clause 2.4.2 of this clause;
>
> 2.4.2 power from time to time by deed naming the individual concerned to exclude from the Beneficiaries any member for

the time being of the Beneficiaries either permanently or for any period specified by the Trustee in such deed;

PROVIDED THAT these powers shall not be exercised in such a way as to cause this Trust to cease to be an Employees' Share Scheme as defined in Section 743 of the Companies Act 1985.

....

3. TRUST PENDING OF APPOINTMENT

UNTIL and subject to and in default of any appointment under Clause 2

3.1 THE Trustee shall pay or apply the income of the Trust Fund to arise before the Distribution Date to or for the benefit of all or such one or more of the Beneficiaries exclusive of the other or others of them as shall for the time being be in existence and in such shares if more than one and in such manner generally as the Trustee shall in its absolute discretion from time to time thinks *[sic]* fit.

....

4. ULTIMATE DEFAULT TRUSTS

SUBJECT as above and if and so far as not wholly disposed of for any reason whatever by the above provisions the capital and income of the Trust Fund shall be held in trust for such charity or charities as the Trustee shall in its absolute discretion determine.

....

8. DISCRETIONARY NATURE OF THIS TRUST

THE provisions of this Trust shall not form part of any Contract of Employment of any Beneficiary and shall not confer upon any person any legal or equitable rights whatsoever (except as discretionary objects of this Trust) and no Beneficiary ceasing to hold the office or Employment by virtue of which he is a Beneficiary shall be entitled to any compensation for any loss of any right or benefit or prospective right or benefit under this Trust Deed which he might otherwise have enjoyed."

10. The First Trust Deed also contained the following relevant definition:

"The Beneficiaries	The present and future employees or former employees of the Company or any company resulting from the amalgamation or reconstruction of the Company and any other individual named as a member of the Beneficiaries by the Trustee in exercise of the powers contained in this Deed from and after the

date of such nomination"

11. The evidence of Mr Angrave (which we accept) was that the No. 1 Trust was established for the purpose of facilitating schemes to encourage employee share ownership in Holdings. Its creation was prompted by the wish of three significant shareholders to dispose of their holdings (some 800,000 shares, amounting to some 20% of the total issued share capital of Holdings) in 1992. We were not provided with details of those schemes, but there were at least three:

(1) A Revenue-approved profit sharing "buy one, get one free" scheme whereby all employees could buy shares in Holdings and be allocated an equal number of free shares from the No. 1 Trust;

(2) Two share option schemes (which appear to have been used only for more senior employees) whereby the No. 1 Trust granted share options over existing issued shares of Holdings held within the trust. One of these schemes was approved by the Inland Revenue, the other was not; and

(3) A share dealing facility, whereby employees were given an opportunity once a year to buy and sell shares in Holdings at a valuation fixed on an annual basis, with the No. 1 Trust standing as buyer of last resort if the numbers of shares to be sold exceeded the number which employees wished to buy.

12. The No. 1 Trust also purchased shares from departing employees (who were required, under Holdings' articles of association, to sell their shares on leaving employment).

13. We accept that there was no specific plan to use the No. 1 Trust as a conduit for making cash payments to employees until the sale to Thomson was being considered. Neither was there any hope or expectation of any such payments on the part of employees generally until that time. The No. 1 Trust was used purely as part of the mechanism for making the employee share ownership arrangements work properly. Mrs Adshead gave evidence (which we accept) that until the sale was being talked about, she was not even aware that the No. 1 Trust existed as such, she simply had a general awareness that there was some kind of structure to facilitate employee participation through share ownership and options.

The financing of the No. 1 Trust

14. Part of HMRC's argument was that the money distributed by the No. 1 Trust after the sale of Holdings represented, to a significant extent, money that had been contributed to the trust by the Appellant. We attempted to assess the strength of this argument by reference to the information available to us as to the amounts and sources of the money received by the No. 1 Trust over its lifetime.

15. The money which the No. 1 Trust received came from several different sources:

(1) It took out a loan facility from a bank (guaranteed by Holdings and/or the Appellant) of £1,500,000, of which it drew down £895,000 at an early stage to "kick start" the trust fund. As Mr Angrave told us that the shares were worth £1.06 at the time the No. 1 Trust was established, we infer that the bank loan was the source of funding to buy the initial 800,000 shares when the No. 1 Trust was set up (as the purchase price for the shares would have been £848,000 plus stamp duty and fees).

(2) It is clear that the Appellant and Holdings also contributed to the No. 1 Trust; we were given a list of contributions over the period from 7 April 1992 (when an initial £100 was contributed as contemplated in the No. 1 Trust Deed) up to 7 December 2001 (since when, we were told, no further contributions had been made). The total contributions in that list were £1,780,823.57.

(3) It is also clear that the No. 1 Trust received cash payments from employees who bought shares from it (either as part of the approved profit sharing scheme or in the annual dealing window) or who exercised options over shares granted by it. We have no details of the amounts of these payments.

(4) The No. 1 Trust also received dividends on the shares it held.

(5) Clearly when Holdings was sold, the No. 1 Trust received a large payment (partly in cash but largely in loan notes) on the sale of the shares it sold.

16. We had very little information to help us form a view on the amounts that had been received under these various headings, but the following items were provided, which enabled us to obtain a broad grasp of the picture.

17. We were given a copy of the accounts for the No. 1 Trust for the year ended 5 April 2001. These showed that during that year, the No. 1 Trust had received £148,037 contributions from "participating companies", it had made a profit of £77,386 on "exercise of shares" (which we take to mean on exercise by employees of share options granted by the No. 1 Trust); it became entitled to £183,090 of dividends on the shares it owned; and it became entitled to £1,790 of interest receivable, presumably on cash held by it on deposit. It held a total of 1,144,315 shares in Holdings. 724,581 of those shares were held subject to options in favour of employees (and upon exercise of those options at the prices set out in the accounts, the No. 1 Trust would have made a profit of £529,885.26); the remaining 419,734 shares were held as free trust assets. Those accounts also showed that the No. 1 Trust had repaid all but £350,000 of its original bank loan.

18. We were given a copy of the offer that was made by Thomson for Holdings on 6 December 2001. The basic price per Holdings share was £9.33, with the possibility of some deferred consideration in addition (though we heard no evidence as to the amount of deferred consideration actually paid).

19. It was quite impossible to reconstruct from the information we were given even an approximate view of what proportion of the overall cash received by the No.

1 Trust over its lifetime had been paid by way of contribution (as opposed to dividend) from the Appellant or Holdings.

20. Mr Angrave gave evidence (which we accept) that the No. 1 Trust held 441,522 shares (representing approximately 11.38% of the issued share capital of Holdings) at the time of the sale to Thomson on 28 December 2001 (this figure had increased from 419,734 on 5 April 2001). Thus the No. 1 Trust would have realised approximately £4.12 million on the sale of its unencumbered shares. Even if the increase in its unencumbered shares was attributable entirely to the lapse of options, it would still also have realised option exercise proceeds of between £1.88 million and £1.95 million on the exercise of options. The accounts appear to indicate that the aggregate cost of all these shares to the trust was a little over £2.5 million, and therefore it would be realising a profit of approximately £3.5 million from the sale as a whole. This tends to suggest that the profits generated within the No. 1 Trust significantly outweighed the cash contributions from the Appellant, but clearly it is not possible to identify a direct link between any particular cash payment out of the trust and any particular source of income beyond observing that most of the No. 1 Trust's income was not cash contributed directly by the Appellant.

21. It must however also be recognised that the profit which the No. 1 Trust made on the disposal of all these shares (and the dividends which it had received and profits it had made on the shares in the meantime) could be regarded as deriving, to some extent, from the original contributions of the Appellant which had funded their purchase in the first place or from the indirect support which the Appellant had provided by guaranteeing the bank loan made to the No. 1 Trust.

The sale to Thomson and its immediate aftermath

22. The key details are set out in paragraphs 5 to 9 of the statement of facts at [6] above.

23. As negotiations for the sale progressed, the directors of the No. 1 Trustee realised that it would be left holding a large amount of cash after the sale which would need to be dealt with in some way.

24. On 29 November 2001, shortly before the sale to Thomson was agreed, a meeting of all the staff of the Appellant was convened at Mere Golf Club in Cheshire. The purpose of the meeting was to inform the staff about the impending sale. At that meeting, Mr Angrave and Mr Gardiner gave a presentation in which they mentioned the possibility that the No. 1 Trust might make some payments out to the staff after the sale had gone through, though there was no timetable. They emphasised that nothing could be counted on, but they hoped that every eligible employee would get something. Mrs Adshead gave evidence (which we accept) that it was only when she had a briefing meeting with Mr Angrave shortly before the Mere Golf Club staff meeting that she discovered that the No. 1 Trust might be planning possible cash payments to staff. Until that time, she had not really known of the trust's existence, let alone the possibility that it might make cash payments.

25. There were some changes made to the board of directors of the No. 1 Trustee on 4 December 2001. Following those changes, the board comprised Mr Gardiner and Mr Roxborough (both newly appointed), Mr Angrave and Mr Denis Hall (consultant to Knights LLP, solicitors for Holdings and its shareholders).

26. Thomson's offer document for the purchase of Holdings was issued on 6 December 2001. The sale was completed on 28 December 2001, following which Mr Angrave and Mr Roxborough continued as directors of Holdings, the Appellant and the No. 1 Trustee. There were three non-executive directors of Holdings appointed by Thomson, which remained the position until that number reduced to two on 10 July 2003. A similar structure existed on the board of the Appellant.

27. Mr Angrave and Mr Roxborough gave evidence (which we accept) that they were very clear in their minds about the distinction between their roles as directors in the Appellant and Holdings on the one hand and as directors of the No. 1 Trustee on the other. When discussing trust business, they met away from the Appellant's premises.

The decision to pay out the trust funds

28. In the early part of 2002, the four directors of No. 1 Trustee discussed various options of what to do with the funds in the trust. They considered alternatives other than payment to the employees. But in the end they decided that the only satisfactory solution was a cash-based system.

29. After some further discussion, they decided on a scheme which was intended to reward the employees who had performed particularly well up to the time of the sale. They decided to base it on the Appellant's bonus structure, and in particular the last staff grading which had taken place in December 2001.

30. Mindful of their obligation to consult, they sent a letter dated 5 September 2002 to Mr Noble, the new main Thomson nominee director on the Appellant's board (whose appointment had not yet been finalised, only taking effect on 22 October 2002), outlining their proposals. That letter had attached to it a draft of a letter which the No. 1 Trustee proposed to send to the employees involved, plus a spreadsheet setting out all the individual payments. The letter referred to the obligation to inform and consult, and said that Mr Angrave would call Mr Noble in the near future "to ensure that you have received the documentation and to cover any queries you may have". Much to his surprise, Mr Noble called him within an hour of the letter being sent by email, thanked him for consulting and made no further comment. So far as all sides were concerned, that was the end of the consultation.

31. The essential structure proposed was to share the available funds, in a number of instalments, amongst the employees of the Appellant who were in post on 28 December 2001, in proportion to their bonus payments from the Appellant for that year (which were calculated using their December 2001 performance grading) but with an adjustment to reward longer serving employees. To receive a payment, an individual had to be still in the employment of the Appellant on the payment date.

Employees who had held 5% or more of the shares in Holdings at any time in the ten years up to the sale were excluded, but there was also a minimum payment of £200 to every employee as at the sale date who was still employed, even those who would otherwise qualify for nothing. There were also one or two specific adjustments to cover individuals whom the trustee directors considered deserved special treatment. The reason for the instalment payment proposal was that the No. 1 Trust still held loan notes for much of its sale proceeds, and in order to fit into the timetable for encashment of those loan notes, it was expected that the employees would receive three equal payments at yearly intervals.

32. Mr Gardiner gave evidence (which we accept) that part of the thinking of the director/trustees in basing the discretionary payment structure on the Appellant's bonus scheme was that they were sensitive to the possibility of undermining the Appellant's management if they gave significant payments to individuals who were not performing at what he described as the "going the extra mile level".

33. Preparations were then made to finalise the notification to the employees and the first payment. The trustee/directors formally approved the proposals at a meeting held on 17 September 2002. By letter dated 30 September 2002 to Mrs Adshead, the No. 1 Trustee reminded her of the background and then informed her that a specific payment of £10,800 would be made to her by 31 October 2002. Similar letters were sent to all eligible employees. The letter stated that "at this stage we are obliged to clearly state that we can only give you an indication of possible future intentions after the date of this first payment. You must not assume these are confirmed."

34. In fact the payment made to Mrs Adshead was much larger than £10,800, and she gave evidence that she had been "blown away" by the surprise of it. She understood that she had received more than her "formula" amount, but she was quite clear that so far as she was concerned the whole payment had been an unexpected surprise.

Independence of the No. 1 Trust from the Appellant

35. We accept the evidence of Mr Angrave and Mr Roxborough that they were careful to separate their trustee director roles from their management role at the Appellant. They had legal advice from time to time from their fellow director Mr Hall on such matters.

36. In early 2002 a dispute arose with the Appellant's auditors, who were in the course of preparing its December 2001 accounts. They were seeking to argue that the No. 1 Trustee and the No. 2 Trustee (with their respective assets) should still be included in the group for accounting purposes.

37. Eventually they accepted that this should not be done, partly on the basis of a letter of representation from Holdings (signed by Mr Angrave) which included the following:

"**Specific matters in relation to the Employee Benefit Trusts**

We confirm, to the best of our knowledge and belief and having made appropriate enquiries of other directors and officials of the company's*[sic]*, the following representations in relation to the assets held in the Gardiner-Caldwell Employee Benefit Trusts (the trusts).

- The trusts are entirely independent from the company and we believe they exist solely to distribute the assets that have arisen from the sale of the shares to Thomson Healthcare Plc;
- The Group's directors have no control over the assets held in the trusts;
- The Group's directors will not seek to influence the trustees in any way;
- The directors are of the opinion that there will be no direct future economic benefit to Gardiner Caldwell (Holdings) Limited or its subsidiary undertakings arising from the assets held in the trusts, and are not aware of any such benefit;
- The Group's directors will continue to remunerate our employees on a consistent basis as in prior years and will not rely on any distribution from the trust in lieu of remuneration to employees;
- If requested by the trustees we will provide to them information concerning employees as at 28 December 2001, or persons who have left our employment prior to that date, sufficient to enable the trustees to make contact with the individuals involved and subject to legal requirements. We will not provide the trustees with information:
    - Concerning employees whose first employment with us commenced after 28 December 2001
    - Relating to any employees performance post the 28th December 2001

In our opinion, the future results of the Group will not be influenced by the decision of the independent trustees in how to distribute the assets of the trusts."

38. Based at least in part on these representations, the auditors agreed to the No. 1 Trustee and the No. 2 Trustee (and their respective assets) not being consolidated in the accounts of Holdings.

The payments made by the No. 1 Trust

39. The first set of payments was made at the end of October 2002, totalling some £1.35 million. As a result of the payments (from which PAYE was deducted) the No. 1 Trust paid £144,978.51 total secondary Class 1 NICs. In addition, it deducted and

accounted for £34,304.05 by way of primary contributions. If this appeal succeeds, it will recover the £144,978.51 secondary Class 1 NICs it paid.

40. The next set of payments was made in October 2003. Although PAYE was deducted and accounted for, no Class 1 NICs were deducted or accounted for (primary or secondary), relying on the decision in *Channel 5 TV Group Limited v Morehead (Inspector of Taxes)* [2003] STC (SCD) 327, which was handed down in May 2003 and subsequently widely publicised.

41. In anticipation of a change in the law, a further set of payments were made in February 2004. Again, although PAYE was deducted and accounted for, no Class 1 NICs were deducted or accounted for (primary or secondary).

42. It is agreed that if the Appellant is liable to pay primary and secondary NICs for the two distributions made in 2003-04 by the No. 1 Trust (which totalled £1,626,267), its total liability will be £241,027.59, being £46,040.94 primary contributions and £194,986.65 secondary contributions.

43. A further set of payments was made during the year 2004-05. PAYE and NICs were operated in full on these payments and there is no dispute that this was the correct treatment.

The appeal

44. The Appellant and HMRC agreed to treat Mrs Adshead's case as representative of all the payments made in 2002-03 and 2003-04.

45. On 13 November 2009, HMRC issued a Notice of Decision addressed to the Appellant (under its then name of Knowledgepoint 360 Group Limited). It read as follows:

> "My decision is that:
>
> That Knowledgepoint 360 Group Ltd is liable to pay primary and secondary Class 1 contributions for the period 6th April 2003 to 5th April 2004 in respect of earnings of Mrs V M Adshead *[NI number given]*.
>
> The amount Knowledgepoint 360 Group Ltd is liable to pay in respect of those earnings is *[amount deleted]*.
>
> The amount that Knowledgepoint 360 Group Ltd has paid in respect of those earnings is *[amount deleted]*.
>
> The difference is due to Class 1 contributions on payments made by bonus payments."

46. This is the decision now appealed, and the parties are agreed that the outcome of the appeal will determine the NIC liability in relation to all payments made during the years 2002-03 and 2003-04, and will therefore determine the Appellant's claim for repayment of the secondary Class 1 contributions it paid in 2002-03 as well.

The law

47. There is a large measure of agreement between the parties as to the law to be applied.

48. It is common ground that an NIC liability (both primary and secondary Class 1) would have arisen in relation to all the payments made by the No. 1 Trust in both 2002-03 and 2003-04 were it not for the effect of paragraph 5 of schedule 3 to the Social Security (Contributions) Regulations 2001 ("Para 5"), which appears in a list of items which are to be "disregarded in the calculation of earnings for the purposes of earnings-related contributions", and which at the relevant time provided as follows:

> "**5 Gratuities and offerings**
>
> (1) A payment of, or in respect of, a gratuity or offering which satisfies either of the conditions in this paragraph.
>
> (2) The first condition is that the payment –
>
> (a) is not made, directly or indirectly, by the secondary contributor; and
>
> (b) does not comprise or represent sums previously paid to the secondary contributor.
>
> (3) The alternative condition is that the secondary contributor does not allocate the payment, directly or indirectly, to the earner."

49. The predecessor of this provision (which was to the same effect, and nothing turns on the differences in the wording) was considered at some length in the *Channel 5* case. In that case, a venture capitalist chose to pay over some of its profit (earned on a sale of its investment in a company) to the employees of the company after the sale had gone through. Its motivation was that it had earned more than its target level of profit from the investment and it wished to reward the employees of the company who had effectively created that super-profit. It therefore asked the company's chief executive to decide how to allocate the payment it wanted to make, wishing the payment to go to the people who had contributed most to the creation and value of the company. The chief executive consulted with the company's board and proposed to them that all the company's employees should share in the windfall, and some of it should be given to charity. The board agreed and the venture capitalist was told of the proposal, which delighted it – it had expected the windfall would probably be shared amongst a few senior managers. In due course the payment was made by the venture capitalist to a firm of solicitors for onward distribution by them to the employees. These payments came as a complete surprise to all concerned.

50. In deciding whether the payments attracted a liability for primary and secondary Class 1 NICs, the Special Commissioners considered there were four issues, two of which are not relevant in this case (one relates to an ambiguity arising from the drafting of the old provision which has been clarified in Para 5; the other

concerned the question of whether the company could be made liable for the NICs – a matter which is not at issue in the present appeal).

51. The other two issues in that case are also the central issues in this appeal. In fact the second issue really breaks down into two separate points and we consider it would be clearer to address them individually. We therefore consider each of these three issues in turn below.

Applying the law to the facts

The first issue – were the payments to Mrs Adshead "gratuities"?

52. If we find that the payments were not "gratuities or offerings" then the appeal fails immediately. If we find that they were, then the second and third issues become relevant – a finding in favour of the Appellant on either of them will result in the appeal succeeding.

53. We do not consider the word "offering" to be appropriate to describe the payments in this case, and neither side argued that we should do so. We therefore concentrate on the word "gratuity".

54. The Special Commissioners in *Channel 5* considered the meaning of the word "gratuity" at some length and finally suggested a definition of it, with which the parties in the current appeal both agree. We therefore adopt it (though we feel it might usefully be amended very slightly in the interests of clarity– see [76] below). It reads as follows (at [41]):

> "... a gratuity means a voluntary payment given in return for services rendered where the amount of the payment depends on the donor and where there is no obligation on the part of the donor to make the payment."

55. It can readily be seen that this definition itself breaks down into four elements, the first and last of which appear to cover the same point: it is difficult to see what is added to the concept of "voluntary payment" by the phrase "where there is no obligation on the part of the donor to make the payment". We therefore consider this to be a single composite element of the definition. The second element is the concept of "given in return for services rendered"; and the final element is "where the amount of the payment depends on the donor". We consider each of the elements in turn, addressing the arguments raised on them by the parties.

<u>First element of "gratuity" definition – "Voluntary payment/no obligation on the part of the donor to make the payment"</u>

56. Ms Choudhury makes the simple observation that the No. 1 Trust is a discretionary trust and that these payments were made by its trustees entirely voluntarily. They were under no obligation to make payments to Mrs Adshead or anyone else. The trustees' only obligation was to exercise their very wide discretion

in an appropriate manner. If it came to it, they were free under the terms of the trust to pay all the trust assets over to a charity of their choice.

57. Mr Williams, on the other hand, submitted that this was too narrow a view of the situation. He made a number of points in reply, which we have analysed down into four basic submissions.

58. His first submission was this. The background was that the No. 1 Trust was set up with the purpose of providing incentives to employees, and in reality it would be bound to distribute its assets to those employees. He pointed out that the incentive for employees in such arrangements lies not really in "pride of ownership" of company shares, it lies in the prospect of cash payments on a sale of the company if things go well. This must always be in the contemplation of those who design, run and participate in employee share schemes, he argued, and this means that when those schemes do mature into significant cash proceeds (as here), those cash proceeds were impressed with the character of the "incentive" that generated them and could not be regarded as truly voluntary payments.

59. His second submission was that the trustees were (or were controlled by) individuals who were or had been directors of the Appellant, who could be relied on to ensure that the monies were disbursed in line with the general purpose of the trust. As a result, its payments were not really voluntary, they should be seen for what they were, which was a working out of the No. 1 Trust's main object of providing an incentive (ultimately in the form of cash payments) to the employees.

60. His third submission was this. He pointed to the fact that eligibility to participate in each payment from the No. 1 Trust was dependant on continued employment by the Appellant at the time of the payment in question. This created, he argued, a clear "incentive" flavour to the payment which was inconsistent with an entirely voluntary payment.

61. His fourth submission was that Mrs Adshead was aware of the creation and purpose of the No. 1 Trust and had an expectation that she would receive a payment or some other benefit from it. He also asserted that since the whole purpose of the trust was to benefit the employees, "there was always an expectation that it would make such payments" (though he did not identify the holder or holders of that expectation). In effect, he was submitting that the payment was made in satisfaction of her expectations and the absence of a specific legal obligation to make it was insufficient to render it a gratuity.

62. We take Mr Williams' submissions in turn.

63. His first submission has some weight, but we do not accept it. The question we are here concerned with is whether the payments to Mrs Adshead (and, by extension, the payments to all the other employees) were "voluntary" and made in a situation where there was no obligation on the part of the No. 1 Trust to make them. Mr Williams' submission does not really address this point analytically, it essentially says that it is artificial to speak of payments being "voluntary" or to say that they were

made in a situation where there was no obligation to make them in the context of payments out of what is essentially an employee incentive scheme.

64. Whilst it is right to observe that an objective bystander would have a reasonable expectation that payments would be made to employee out of a scheme such as this, a truly objective bystander must accept that there is no legal obligation on the trust to do so. It had power, if the trustees felt it appropriate, to pay the funds to charity or to add non-employees to the class of beneficiaries and make payments to them.

65. And crucially, even if Mr Williams' assertion broadly to the effect that "these funds were always going to be paid out to the employees" is accepted, we must remember that each payment must be considered individually to see whether it satisfies the "gratuity" test – and it is quite clear that the trustees have exercised their discretion separately and individually in relation to the amount actually paid to each employee. Each individual employee could have received either nothing at all, a very large amount of money, or somewhere in between. To the extent that the trustees have exercised their discretion to fix the payment of each employee at what they consider the correct point in this continuum, we consider they have made a voluntary payment to that employee in a situation where there was no obligation to make that payment. Taking Mrs Adshead's situation, there is no doubt that the trustees could have decided to leave her off the list of payees altogether, without her being able to raise any kind of lawful complaint; by instead allocating a large payment to her, they have undoubtedly acted voluntarily, even if one accepts that they were under some kind of obligation to distribute all the trust assets to the employees as a class. Similar reasoning applies to the payment actually made to each employee.

66. We turn now to Mr Williams' second submission. We consider it is really an extension or particularisation of his first submission. We are quite satisfied that the four individuals in question exercised fully independent discretion in deciding on the distributions to be made, and in doing so they were deciding on payments which were voluntary and made in a situation where there was no obligation to make those payments. In a situation where (as we have found) the individuals in question acted independently of the Appellant and Holdings in reaching their decisions, we do not consider that the fact that two of those individuals were also directors of the Appellant and Holdings makes any difference to our view on Mr Williams' first submission.

67. As to Mr Williams' third submission, we agree that the creation of a link between receipt of the payments and continued employment with the Appellant is an unexpected element of a gratuity, and we have some misgivings about it. Mr Angrave explained away the link as a mere administrative convenience – there could be all sorts of difficulties about tracing former employees and making payments to them if they were no longer in the employment of the Appellant and this condition did away with those difficulties. When considered in the context of the hope of further payments which would have been engendered in the employees when they received the initial letter informing them of the "continuing employment" condition, this comes perilously close, in our view, to undermining the "voluntary" status of the second and subsequent payments (including the payments the subject of this appeal).

68. The letter sent out to employees in advance of the first payment did indicate that future payments were contemplated, including the following text:

> "... it is envisaged that overall payments will be made in a number of stages"

> "... overall payments will need to be made on a staged basis into the future. Indications of the projected cash flows suggest that each overall total anticipated but not guaranteed payment will be split into three equal staged payments. It is the intention of the Trustees to arrange that the first staged payment will be made by 31st October 2002 subject to all related administrative procedures being complete satisfactorily. It is anticipated (but not guaranteed) that two further equal staged payments should be made within 2 years of the first staged payment."

69. Against this, however, the letter in question made it equally clear to the employees that even if they continued in employment, the making of any further payment by the No. 1 Trust was still very much discretionary: it included, for example, the following text:

> "At this point we are legally obliged to state clearly that this information can only provide an indication of possible future intentions regarding the relevant payments. **It needs to be made clear that you must not in any way assume that the possible future intentions described are fixed and confirmed at this stage.**"

> "...**please be mindful that this can only provide an indication of possible future intentions and you should not assume that these are fixed and confirmed at this stage."**

70. We find the point finely balanced, but in the end we have reached the view that the linkage between continued employment and possible eligibility for further payments is not sufficient to displace our view that the payments remained "voluntary" and made in circumstances "where there is no obligation to make the payment".

71. We turn now to Mr Williams' fourth submission. We accept Mrs Adshead's evidence that she was completely unaware of the possibility of the No. 1 Trust making cash payments until Mr Angrave briefed her on it shortly before the Mere Golf Club staff meeting in November 2001. At that stage it was still only presented to her and the rest of the employees as a tentative possibility. We do not see how this could be regarded as engendering an expectation of an incentive payment with a view to inducing Mrs Adshead (or any other employee) to continue in employment and work to make the sale a success. By the time they became aware of the possibility, the sale was only a few days short of being agreed. There was no indication given to employees as to how the payments might be structured (for the very simple reason that no thought had yet been given to that question). There was at that stage no hint of any "continuing employment" condition applying to the calculation of the payments. So whilst the employees will have taken a general good feeling and a hope for some future payment away from the meeting, we do not consider they would have

felt any expectation of, still less any entitlement to, any payment. In short, we find that they had been led to expect there was some possibility of a gratuity of some kind in connection with their past service and nothing more.

72. We therefore reject Mr Williams' submissions on this point and agree with Ms Choudhury that this first element of the "gratuity" definition is satisfied.

Second element of the "gratuity" definition – "Given in return for services rendered"

73. Ms Choudhury submitted that the position in this case was on all fours with the *Channel 5* case. In that case, the Special Commissioners held that the payments were "gifts given in return for the fact that the employees had contributed to the creation and increase in value of the appellant, which became a successful investment for the investor".

74. Mr Williams submitted first that there was "no evidence that the recipients of the payments performed services for the trust analogous to those performed for the investor in the *Channel 5* case".

75. He also submitted that, once again, the nature of the No. 1 Trust as payer should be taken into account, and it materially changed the nature of the payment. He said that the increase in value of the No. 1 Trust's investment in Holdings shares was not analogous to that in the *Channel 5* case because "here the whole purpose of the trusts and their investments were to benefit the employees". In the terms of this element of the "gratuity" definition, we take him as submitting that there was no element of reciprocity between the payer and the payee, no element of payment for services which were of benefit to the recipient of those services; rather there was a degree of circularity (a word which he used several times) – the efforts of the employees (including Mrs Adshead) were self-serving in that they simply resulted in an increase in value of an asset which they were destined to share in at some future time by way of cash payment.

76. We deal first with Mr Williams' first submission. Clearly, there were no services being rendered directly by the employees (including Mrs Adshead) to the No. 1 Trust and, to that extent, it is a little difficult to find that the payments were made "in return" for such services. But the same observation could be made about the payments in *Channel 5*, and the point did not trouble the Special Commissioners in that case. It might perhaps be a little more accurate if the definition of "gratuity" propounded in that case had included the phrase "in recognition of services rendered" rather than "in exchange for services rendered", and we would have considered that change appropriate to the *Channel 5* definition if the parties had not agreed to it in its present form; but nevertheless we are satisfied that there is no distinction, for the purposes of Mr Williams' first submission, between the *Channel 5* case and this appeal.

77. His second submission carries a little more weight. We agree that, as a general proposition, there is some difference in nature between an employee's service which enhances the value of a truly independent investor's shareholding in the

employer and one which enhances the value of a trust fund which is established to provide benefits to employees (including that employee in particular). In some sense, it can be said that in the latter situation the employees are simply working to enhance the value of an asset in which they have an interest, rather than working for the benefit of a truly independent third party who subsequently makes a payment as a mark of his appreciation.

78. But we still consider that his submission misses the point, for two reasons. First, the phrase "given in return for services rendered" does not necessarily imply that a careful analysis should be made of what services have been rendered and to whom; all that is necessary is to establish that a payment has been made because the recipient has performed some service for which the payer wishes to show approval or gratitude (in contrast to the situation where the payer makes a completely unsolicited payment out of the blue by reason, for example, of sympathy, admiration or natural love and affection). In the *Channel 5* case itself, the Special Commissioners (at [44]) effectively agreed as much when they said that the payments were "gifts given in return for the fact that the employees had contributed to the creation and increase in value of the appellant" – there is no hint in that key conclusion that the Special Commissioners were concerned with a careful analysis of precisely what services the employees had performed and for whom, nor did they consider that question at length anywhere else in their decision.

79. We are quite satisfied that in this case, the No. 1 Trust (and its trustee/directors) made the payments they made to Mrs Adshead because they wished to show approval of her efforts. They applied their minds carefully to the amount to be paid to her, to reflect the value of her efforts. Similar observations apply to all their payments to employees. It matters not, in our view, that they were acting as trustees of an employee benefit trust when doing so. They were not bound to pay any particular amount (or indeed any amount at all) to any particular employee. They could have decided that the good price achieved on the sale of Holdings was attributable to market conditions or other factors entirely beyond the control of the employees and therefore it would be more appropriate to pay the cash to charity than distribute it amongst the employees. They did not do so, but it is in our view misconceived for HMRC to argue that the payments received by each of the employees were little more than their entitlement under an incentive scheme.

80. Second, it is clearly the state of mind of the payer and not of the payee which is relevant to deciding whether a payment is "given in return for services rendered" (or, in our preferred formulation, "given in recognition of services rendered"). By arguing that the No. 1 Trust was not truly independent of the Appellant in making decisions about payments, Mr Williams has effectively accepted as much. From the careful way in which the four individuals concerned went about the task of deciding how to distribute the funds in the No. 1 Trust, we are quite satisfied that they were intending that the payments made should represent individualised expressions of approval for the efforts put in by the recipients in contributing to the overall value of Holdings. As such, we are satisfied that each payment made was "given in return for services rendered" (or, on our preferred formulation, "given in recognition of services rendered") by the individual employee concerned.

81. We therefore reject Mr Williams' submissions on this point and agree with Ms Choudhury that this second element of the "gratuity" definition is satisfied.

Third element of the "gratuity" definition – "Where the amount of the payment depends on the donor"

82. Ms Choudhury submitted that this case was again on all fours with *Channel 5*. The payments were all decided on by the four trustee/directors and neither the recipients nor the Appellant had any involvement in deciding the amount of the payments.

83. Mr Williams pointed to the fact that two individuals who were still at the time executive directors of the Appellant and Holdings (Mr Angrave and Mr Roxborough) were crucial members of the body of four individuals who had effectively decided on the allocation of the payments. Bearing in mind that one of the other two was effectively a non-executive professional adviser, the views of Mr Angrave and Mr Roxborough were effectively determinative. He submitted that this must cast some doubt on whether the amounts of the payments had been truly determined independently of the Appellant.

84. We are satisfied that, as they asserted, Mr Angrave and Mr Roxborough were careful to exercise their judgment as to the amounts of the payments entirely independently of their status as directors of Holdings and the Appellant. Clearly the knowledge they had gained in their capacity as such directors was an important element in their decision making, but that is an entirely different thing from accepting that their decisions were made in some way on behalf of the Appellant or Holdings.

85. We also note that in *Channel 5*, there was if anything an even closer link between the employer and the person who was determining the amounts of the payments. The Special Commissioners however were quite satisfied that the determination by the employer's chief executive was done in his personal capacity and the board of directors of the employer did not become involved, therefore there could be no suggestion that the employer had determined the amounts.

86. We therefore reject Mr Williams' submissions on this point and agree with Ms Choudhury that this third element of the "gratuity" definition is satisfied.

Conclusion on the "gratuity" issue

87. Having found that all three elements of the "gratuity" definition are satisfied, it follows that we are satisfied the payments to Mrs Adshead (and, by extension, to the other employees) were gratuities.

88. The point then arises as to whether the payments satisfy either what might be called the "independent payment" condition or the "independent allocation" condition. Satisfaction of either of these conditions will suffice for the appeal to succeed.

89. We turn first to what we consider the easier of the two conditions, the "independent allocation" condition.

Second issue - No allocation by the Appellant

90. The condition to be satisfied here is that "the secondary contributor [i.e. in this case the Appellant] does not allocate the payment, directly or indirectly, to the earner." There is clearly some overlap here with the third element of the "gratuity" definition, which was reflected in the submissions made by the parties.

91. Ms Choudhury submitted that the evidence was clear: the individuals who made the decisions about allocation were all acting entirely independently of the Appellant, and the fact that three of them were either current or former directors of it was irrelevant, given the way in which they approached the task of deciding on the allocation.

92. Mr Williams' submissions on this issue all revolved around the central point of independence. He essentially argued that in a situation where the allocation decision was being taken by four individuals, two of whom were current serving directors of the Appellant, one of whom was a professional trustee whose role was mainly the giving of generic legal advice, and the other of whom was the retired chairman of the Appellant's parent company, the only realistic view of the situation was that the Appellant was effectively making the allocation. This was reinforced by the fact that the individuals had based their scheme of distribution very heavily on the Appellant's own bonus structure.

93. He also sought to argue that the consultation process with Mr Noble on behalf of Thomson was inconsistent with the assertion that the decisions on allocation had been taken totally independently, and he raised a similar argument that the expressed wish of at least one of the individuals concerned "not to undermine the management" of the Appellant in allocating the payments also implied a lack of independence from the Appellant.

94. At all times relevant to the allocation decisions, there were two trustees of the No. 1 Trust: Mr Gardiner (the retired chairman of the Appellant and Holdings) and the No. 1 Trustee (see paragraph 9 of the statement of facts at [6] above). In strict legal terms, they would have had to act unanimously and therefore either Mr Gardiner or the No. 1 Trustee could have vetoed any proposed scheme of distribution. Unanimous agreement to the appointment of a new trustee would also have been required, so this deadlock could not have been broken in that way. The No. 1 Trustee was of course controlled by its directors, a majority of whom (Mr Angrave and Mr Roxborough) were current directors of Holdings and the Appellant. The two issued shares of No. 1 Trustee were jointly held by Mr Hall (the solicitor) and Mr Gardiner and therefore it could be expected that Mr Gardiner would have had the power to remove Mr Angrave and Mr Roxborough as directors of No. 1 Trustee and appoint his own nominees in their place. Thus the most likely means of breaking a deadlock would have involved Mr Gardiner (the retired chairman) taking control.

95. This is an important part of the background in assessing the independence of the decision making process, but far more important is an analysis of what actually happened in the course of that process.

96. We find that all four of the individuals concerned were extremely careful to distinguish in their own minds the role and responsibility which they had in relation to the trust from their other roles and responsibilities (especially Mr Angrave and Mr Roxborough). We find that the use of the Appellant's bonus model as the starting point for the allocation was entirely logical, and it was just that – a starting point. It is clear that Mrs Adshead, for example, received much more than she would have done purely on the basis of the model. It is also clear that payments of £200 were made to numerous employees who would not have qualified for any payment if the Appellant's bonus model had been used in a mechanical fashion. An extra factor – length of service up to the sale – was added into the equation. All these are very clear indicators that the trustees did indeed exercise their own independent judgment and not simply go along with the Appellant's views on the allocation. We also find that there was nothing in Mr Williams' submission about the consultation with Mr Noble. We find that the consultation connoted no element of actual involvement in the decisions by Mr Noble. The payment structure was effectively presented to him as a fait accompli (as was permitted under the terms of the relevant deed) and he accepted it as such.

Conclusion on the "allocation" issue

97. We accordingly have no difficulty in finding that there was no allocation, direct or indirect, of any payment by the Appellant.

Third issue – No payment by the Appellant

98. The conclusions we have reached above are sufficient to dispose of the appeal. However, we examine the third issue in case we are wrong on the second issue.

99. The language of Paragraph 5 was clearly drafted with situations such as restaurant tips primarily in mind. There is therefore a little awkwardness in interpreting it in the present context.

100. The condition reads as follows:

> "The first condition is that the payment –
>
> (a) is not made, directly or indirectly, by the secondary contributor; and
>
> (b) does not comprise or represent sums previously paid to the secondary contributor."

101. There was no suggestion in this case that the payments had been made directly by the Appellant. Both parties agreed that the wording in paragraph (b) could effectively be ignored in the present case as the payments made to employees clearly

did not comprise or represent sums previously paid to the Appellant (that paragraph is more apt to cover distribution of restaurant tips by a troncmaster). What the Appellant had to establish, therefore, in order to succeed on the third issue was that the payment had not been made indirectly by the Appellant.

102. The question that arises, when considering this issue in the context of the events that occurred, is what would amount to "payment made indirectly by the Appellant". To put it another way, what are the required elements of "payment made indirectly by the Appellant", and are those elements present in this case?

103. Some examples help to illuminate this question. If, for example, a company paid a sum of money to an intermediary with instructions to pass it on to the company's employees, that would clearly amount to an indirect payment. Similarly, if a company paid a sum of money to a body (say, a trust) established solely for the purpose of providing benefits to the company's employees, but without giving any instructions for its disbursement, a payment of that money by that body to those employees would clearly have been expected by the company and, when made, it would amount to an indirect payment by the company.

104. One might generalise and say that any scheme or arrangement which has been designed to deliver to employees at the end money which is introduced at the beginning will give rise to an indirect payment by an employer if it introduces the money itself at the beginning (or makes arrangements for anyone else to do so on a basis that the cost ultimately falls back on the employer).

105. But the situation in this case is more complex. The various sources of funds for the No. 1 Trust are summarised at [15] above.

106. Before any payment from the No.1 Trust to employees can be said to be paid indirectly by the Appellant, it must be shown that the money actually originated from the Appellant (or from elsewhere but at the Appellant's ultimate expense). In looking at the various sources of the trust's money which it paid out to the employees, a number of points arise:

(1) There were clearly £1.8 million of contributions from the Appellant and Holdings (given the close relationship between Holdings and the Appellant, we do not consider it necessary to differentiate between them for this purpose – no evidence was put forward to persuade us that any part of the contributions on the list we were provided with should be excluded from reckoning for these purposes.) On any view, this money can be regarded as originating from the Appellant.

(2) The bank loan of £895,000 that was used to "kick-start" the trust had been repaid in full before any distributions were made to employees by the trust, so this money can have formed no part of the sums distributed.

(3) The No. 1 Trust has also received dividends on the shares it has held. Though these will have been shares of Holdings rather than the Appellant, we do not differentiate between them for this purpose (and in any event we

were told that the Appellant was the main trading company in the group, so we assume the profits to fund those dividends will have originated wholly or mainly from the Appellant). No evidence was put before us (except in relation to 2000-01) as to the amounts of dividend received.

(4) We have no evidence of the aggregate amounts of the payments received from employees, except that we know they will have paid approximately £1.9 million to the trust on exercise of share options in the context of the sale. That money clearly originated from outside the Appellant.

(5) The £4.12 million cash and loan notes received by the trust on the sale, to the extent comprised in the ultimate payments to employees, also clearly originated from an outsider (in this case, Thomson).

107. We were told that the No. 1 Trust had distributed around £3 million in the first three distributions (October 2002, October 2003 and February 2004). We were not informed of the amount of the October 2004 distribution (though the indications were that it would have been approximately £1 million, given the original intention of paying three roughly equal instalments which was hastily adjusted in February 2004 when a change in the law was imminent); and we were told that the fund still stands at some £2 million. We know that the trust received some £6 million from employees and Thomson on the sale of Holdings (and the associated exercise of share options), which clearly did not originate directly from the Appellant. We know that the only assets in the trust at the time of the sale would have been its free and encumbered shares (apart from a small amount of cash). It therefore seems logical to conclude that the cash available for distribution to the employees was that which was generated by the sale (both on disposal of free shares and exercise of options over the remaining shares).

108. At first sight, it is tempting to conclude that any distribution of the £6 million available to the trust following the sale cannot include any element of indirect payment by the Appellant, as all of that sum clearly originated from Thomson or the Appellant's employees.

109. However, Mr Williams submitted that we should take account of the fact that it was the Appellant's direct funding (by way of its £1.78 million of contributions) and its indirect funding (by way of its guarantee of the trust's loan from its bank) which got the trust fund under way; all the subsequent profits derived, he submitted, from this original funding. He went on to say that:

> "the trusts were created expressly for the purpose of benefiting the employees, so that the payments by the trustees were the fulfilment of the employer's scheme to reward its employees. In these circumstances it is reasonable to conclude that the payments were made indirectly by the employer."

110. We cannot agree with Mr Williams' submission. The question we have to answer is whether the payments to Mrs Adshead (and, by extension, the other employees) were made indirectly by the Appellant. In a situation where the Appellant

had contributed £1.78 million gradually over a period of nearly nine years (the vast majority of it more than three years before the sale), we find it impossible to agree that it had thereby indirectly made payment of (in aggregate) a much larger sum, including the payment to Mrs Adshead the subject of this appeal.

Conclusion on the third issue

111. For these reasons, we therefore find that the payments to Mrs Adshead were not made, directly or indirectly, by the Appellant.

Decision

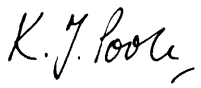
112. We find that the payments to Mrs Adshead in 2003-04 were "gratuities" within the meaning of Paragraph 5 (see [87] above).

113. We find that the Appellant did not allocate those payments, directly or indirectly, to Mrs Adshead (see [97] above).

114. We find that the payments to Mrs Adshead were not made, directly or indirectly, by the Appellant (see [111] above).

115. The appeal therefore succeeds.

116. 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.



KEVIN POOLE
TRIBUNAL JUDGE
RELEASE DATE: 30 June 2011