TC03297

Appeal number: TC/2013/02365

FIRST-TIER TRIBUNAL
TAX CHAMBER

Employment income – payment under Compromise Agreement – whether attributable to future right to receive shares – whether taxable under s 22 TCGA-held – contingent right to be offered shares in the future not an asset for CGT purposes – whole of sum taxable as employment income – appeal dismissed.

MR ISMAIL G ESSACK **Appellant**

- and -

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

TRIBUNAL: JUDGE RACHEL SHORT
MR TOBY SIMON

Sitting in public at 45 Bedford Sq London on 14 November 2013

Mr Essack and Mr Gulabivala for the Appellant

Mr Linneker, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. This is an appeal against an assessment of £15,857.37 of income tax for the 2009/10 tax year in respect of a payment of £200,000 made to Mr Essack as part of a Compromise Agreement with his employer, Ignition Entertainment Limited (Ignition) on 19 May 2009.

2. The Appellant is appealing on the basis that £145,000 of the £200,000 paid to him is not taxable as employment income either as earnings as defined by s 62 Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") or as a termination payment under s 401 ITEPA, but as a capital gain from the disposal of share rights in Ignition.

3. Mr Essack's tax return for 2009/10 included a disposal of £170,000 relating to share rights, with a base cost of £25,000 from March 2003, a deduction for entrepreneurs' relief of £63,529 and resulting capital gains of £69,311.

4. HMRC issued a closure notice on 6 December 2012 assessing Mr Essack to a total of £24,041.20 of income tax for 2009/10 in respect of the payment he received from Ignition on the basis that the payment was subject to income tax as employment income.

Facts

5. Mr Essack was hired by Ignition in January 2003 and worked for them until 12 June 2009 when his contract was terminated. Ignition designed computer games and Mr Essack was the finance manager. At the time of his resignation Mr Essack earned £110,000 pa.

6. During Mr Essack's term of employment, Ignition went through a number of changes in ownership. In May 2002 IVP, said to be a Canadian company, acquired all the shares of Ignition. In March 2003 Potters Limited acquired 100% of the shares of Ignition from IVP. In March 2007 there was a company reconstruction and UTV Communications (UK) Limited ("UTV") acquired 7 million shares with Potters Limited holding the remaining shares.

7. Due to Ignition's cash flow problems during 2006 and 2007 employees, including Mr Essack, were asked to forego their salaries in return for loans to Ignition representing their unpaid salaries.

8. The Shareholders Agreement of 12 March 2007 under which UTV acquired its shares in Ignition included, at Clause 5(a)(i) a reference to an "Employee Option Plan". We were told that no shares were ever issued under this option pool arrangement. Clause 5(a) (i) stated

> "*the Company shall take steps towards adopting a Share Option Plan, allocating options over such number of B ordinary Shares aggregating to 15%*

of the Ownership ("Option Pool"). The Company shall grant options pursuant to the Share Option Plan to such members of the Board, such Key Employee(s), such members of the Key Management team and such consultants of the Company ("Option Pool Beneficiaries") and in such manner as maybe decided by the Board".

9. In 2008 additional shares were issued to Potters Limited and at that time a senior employee of UTV stated by email that *"we stand by our verbal commitment of having management stock within people who had foregone their holding at the time of the transaction, in addition to the key employees listed in the agreement"* (email from Amit Banka of UTV to Mr Essack on 15 September 2008).

10. As a result of the appointment of a new CFO in April 2009 Mr Essack decided that he no longer wished to work for Ignition and negotiated a termination settlement. His initial request was for £400,000. After several months of negotiation he agreed to accept £200,000. This award was set out in the Compromise Agreement of 19 May 2009 and Mr Essack's employment was terminated on 12 June 2009. The Compromise Agreement stated at clause 6.1 *"the Company shall pay to the Employee £200,000 as compensation for loss of employment and loss of all and any entitlements to shares in the Company"*. Both Mr Essack and Ignition understood at the time of these negotiations that had Mr Essack taken Ignition to an Employment Tribunal he would have been awarded no more than £76,700.

11. Ignition submitted P45s in respect of the payments made to Mr Essack under the Compromise Agreement; one showing £25,980.77 paid with £7,090.00 of tax due for his employment up to 12 June 2009 and one P45 showing a payment of £170,000 and tax of £34,000 using the BR code.

12. Mr Essack's employment contract entitled him to four weeks notice for up to five years of service with each additional year of service accruing a further week's notice. Mr Essack had worked for Ignition for six years at the time of the Compromise Agreement and so was entitled to five weeks notice. From Tuesday 19 May, the date of the Compromise Agreement, his notice period expired on Tuesday 23 June. Of this he worked almost three weeks, to Friday 12 June 2009.

The Law

13. The relevant legislation is set out at s 401 and 62 of the Income Tax (Earnings and Pensions) Act 2003.

S 401 applies to "*payments and other benefits which are received directly or indirectly in consideration or in consequence of, or otherwise in connection with –*

(a) the termination of a person's employment"

S 62 defines earnings for these purposes as –

(a) any salary, wages or fee

(b) any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth, or

(c) anything else that constitutes an emolument of the employment.

These are the sections relied on by HMRC to tax the whole of the sum paid under the Compromise Agreement.

14. In respect of the capital gains tax charge, the relevant provisions of the Taxation of Chargeable Gains Act 1992 are s 21 (1);

(1) All forms of property shall be assets for the purposes of this Act, whether situated in the United Kingdom or not, including –

(a) options, debts and incorporeal property generally, and

(b) currency …….

(c) any form of property created by the person disposing of it, or otherwise coming to be owned without being acquired.

S 22 TCGA relates to capital sums derived from assets:

(1) Subject to sections 23 and 26(1), and to any other exceptions in this Act, there is for the purposes of this Act a disposal of assets by their owner where any capital sum is derived from assets notwithstanding that no asset is acquired by the person paying the capital sum, and this subsection applies in particular to ……..…..

(c) capital sums received in return for forfeiture or surrender of rights, or for refraining from exercising rights…

These are the provisions which Mr Essack says apply to the £145,000 element of the Compromise Agreement which was compensation for his loss of share rights in Ignition.

Evidence

15. We were given copies of Mr Essack's employment contract and the Compromise Agreement. We were shown a number of emails between senior employees of UTV and Mr Essack from February to September 2008 at the time of the share issue to Potters Limited, discussing potential entitlements under the Share Option Pool. We were also shown a number of emails between Mr Essack, Ignition and UTV employees at the time when the Compromise Agreement was being negotiated. We were referred in particular to the letter of 13 February 2012 from Mr Chadha (CEO of Ignition) to Mr Essack's accountants setting out his view of the payment made under the Compromise Agreement;

"*both parties agreed on a final settlement of £200,000 which was the amount agreed as per the Compromise Agreement. This payment comprised compensation for unfair dismissal of six months salary and the balance was for compensation in lieu of share entitlement*".

16. We were not given any written evidence of a transfer of Ignition shares to Mr Essack or of the grant of any rights under the Share Option Pool or of the conversion of any employee loans into share rights. Mr Essack confirmed that the Share Option Pool was never activated.

17. Mr Essack referred to oral agreements made between him and Mr Chadha as part of the 2007 negotiations with UTV in Mumbai to the effect that managers such as Mr Essack who had foregone salary in order to provide liquidity to the company and aid its cash flow, would have a right to shares in Ignition, but Mr Essack was clear that this was only an oral agreement.

Appellant's Arguments

18. Mr Essack argues that of the £200,000 paid to him under the Compromise Agreement, £145,000 is by way of compensation for his giving up rights to receive shares in Ignition in the future. The £200,000 paid to him under the Compromise Agreement could not possibly only relate to the termination of his employment, representing as it does the equivalent of nearly two years' salary.

19. This right to receive shares was based on an understanding with Ignition from the time when Mr Essack first took up his employment with them and was embodied in the March 2007 Shareholders' Agreement. The rights stated in the 2007 Shareholders' Agreement were not contingent on anything other than the passage of time and the formalities of a board meeting and created a binding contract between Ignition and Mr Essack. These rights were recognised when Mr Essack agreed to give up his salary in exchange for a loan in 2007 when the company was transferred to UTV and shares were put in trust for him as a result.

20. The real nature of this payment is captured by clause 6 of the Compromise Agreement which refers to "*compensation for loss of employment and all and any entitlements to shares in the company*". This is supported by the emails from UTV of 15 and 17 September 2008 discussing allocations of the Share Option Pool and particularly Mr Chadha's letter of 13 February 2012 which makes clear that he viewed the Compromise Agreement as at least in part compensation for loss of a right to shares in Ignition. At least from the time of the 2007 Shareholders' Agreement, Mr Essack had a right to shares in Ignition and this right was revoked as part of the Compromise Agreement.

21. These were rights which were taxable under s 21 and 22 Taxation of Chargeable Gains Act 1992 (TCGA) and were "property" for these purposes. The sum paid to Mr Essack was compensation for the forfeiture of a right to receive shares and fell within s 22(1)(c) TCGA. They were not excluded from these provisions by s 37 TCGA, (which takes consideration which is subject to income tax outside a capital gains tax

charge) because that section only dealt with excluding income tax which arose as a result of capital allowance claims. This capital gains tax treatment is reflected in Ignition's P14 completed for Mr Essack in June 2009 which taxed the £170,000 payment at 20% only, rather than Mr Essack's 40% marginal income tax rate.

HMRC's arguments.

22. HMRC argue that the whole of the payment to Mr Essack is taxable as employment income under either s 401 ITEPA or s 62 (as to £55,000 of payment in lieu of notice). These are widely drafted sections and refer to payments which "*count as employment income*". (s 403 (1) ITEPA). The payment under the Compromise Agreement was made "directly in consideration or in consequence of, or otherwise in connection with the termination" of Mr Essack's employment. Even if Mr Essack did have some right to shares in Ignition, any payment made in respect of that right would still be taxable under s 401 which would take priority over a capital gains tax charge. On HMRC's interpretation of the TCGA rules s 37 is wide enough to cover the income tax charge applied by s 401 and s 62 and is not limited to capital allowance claims, with the result that the ITEPA charging provisions take priority.

23. HMRC pointed out that Mr Essack has not provided any actual evidence that he had a legal right to shares in Ignition. His employment contract did not grant any share rights. Any agreement to forego salary in exchange for a loan to the company and share rights had not been documented. His evidence suggested that he had at best been promised that he would be awarded shares and this is not sufficient to create an asset for s 21 TCGA. A promise over something which could exist at some undefined date in the future is not a right for the purposes of s 22 TCGA.

24. On the drafting of the Compromise Agreement and its reference to "all or any rights to shares", HMRC say that this is simply defensive drafting on Ignition's lawyers part and is not positive evidence that any rights to shares actually existed. Mr Essack had provided no evidence of the fact that shares were put in trust for him as a result of the loans which he made to the company in 2006, nor was there any reference to any disposal of shares to Mr Essack in March 2007. In respect of the employee loan, that is specifically referred to as re paid in the Compromise Agreement without any reference to share rights (Clause 5 states that the employee's management loan of £17, 444 will be repaid). It is only Mr Essack who referred to the valuation of shares and his rights to shares as part of the Compromise Agreement, Ignition never made any suggestion that this was part of the settlement. In any event, even if Mr Essack could demonstrate some intention on behalf of Ignition to award him shares, the intention of the donor is not determinative here.

25. From HMRC's perspective the 2007 Shareholders Agreement is merely an agreement to take steps in the future to create a Shareholder Option Pool and is just a plan which was never in fact acted upon. HMRC accepted that there was much discussion about this plan particularly in 2008 when new shares were being issued, but stress that no awards were ever made under it, nor were any shares or any rights to receive shares awarded to Mr Essack, who was not a party to the 2007 Shareholders' Agreement.

Discussion.

What rights did Mr Essack have to shares in Ignition?

26. On the evidence provided to the Tribunal we agree with HMRC that Mr Essack had no legally enforceable rights over any shares in Ignition. At best he had an oral promise that shares would be offered to him at some time in the future and the mechanism for this was the Share Option Pool. While this might amount to some kind of moral obligation on behalf of Mr Chadha and Ignition, we do not think that this can be treated as an asset for s 21 TCGA purposes or as a right the disposal of which is taxable under s 22 TCGA. Unenforceable promises have not generally been accepted as assets for CGT purposes. Although we are aware of how widely s 22 TCGA has been interpreted, even by reference to decisions such as *Zim Properties Limited v Procter* ([1985] STC 90), we do not consider that s 22 can treat as the disposal of an "asset" rights arising under an oral promise that an asset might be created in the future, which creates at best a contingent obligation on the promisor. If Mr Essack has any "rights" at all, at best they amount to the unsubstantiated opportunity to sue Ignition on the basis of the representations which they had made that shares could be awarded to him. On that basis we do not consider that Mr Essack had rights to any asset to which s 21 or s 22 TCGA could apply.

What did the £200,000 paid under the Compromise Agreement relate to?

27. We agree that this sum is well above the basic amount which might have been paid to Mr Essack for loss of earnings, but we do not think that this leads automatically to the conclusion that it relates only to the loss of rights over the shares. Employers settle with their employees on advantageous terms for a number of reasons, including a wish to avoid litigation and bad publicity. We view the £200,000 as a composite sum which includes in part Ignition's desire to stop Mr Essack taking them to the employment tribunal or making any claims, well founded or otherwise, in respect of the Share Option Pool. While this payment took account of potential claims in respect of Mr Essack's alleged share rights, our view is that it is a payment arising directly from the termination of Mr Essack's employment contract and is paid to him in consequence of, or in connection with, that termination. We note in particular that even had he stayed as an Ignition employee, the evidence suggested that he would not have received shares under the Share Option Pool, which was never activated.

28. Even if we are wrong in our capital gains tax analysis and Mr Essack can be viewed as having a legally recognisable right over shares, we still do not consider that this is enough to take any of this sum outside the very wide ambit of s 401. On these facts all elements of this payment were directly or indirectly related to the termination of Mr Essack's employment. Even if there is a capital gains tax asset here, it is subsumed within the wide reach of s 401 and is taxable as employment income. We agree with HMRC's interpretation of s 37 that it is wide enough to take outside the capital gains tax charge any income on which tax is charged under ITEPA and that these provisions take priority. We cannot see any sensible interpretation of that provision which limits it to capital allowance related claims as suggested by Mr Essack.

29. Before the Tribunal the parties accepted that if the £200,000 was taxable as employment income, it should be allocated as to 11 days' pay in lieu of notice for the unworked period 12 June to 23 June (taxable under s 62) and the remainder should be treated as a termination payment under s 410 taxable subject to the £30,000 threshold at s 403.

30. For these reasons this appeal is dismissed.

31. 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.

RACHEL SHORT
TRIBUNAL JUDGE

RELEASE DATE: 7 February 2014