



3 February 2010

Gray's Timber Products Limited (Appellants) v Her Majesty's Revenue and Customs (Respondents) (Scotland); *on appeal from* [2008] CSIH 11; 2009 SLT 307

JUSTICES: Lord Hope (Deputy President), Lord Rodger, Lord Walker, Lord Brown, Lord Kerr

BACKGROUND TO THE APPEAL:

The Appellant ('Timber Products') is a wholly-owned subsidiary of Gray's Group Ltd ('Gray's Group'). It appointed Mr Alexander Gibson ('G') as its managing director. G became party to a subscription and shareholders' agreement ('the subscription agreement') under which he paid £50,000 to take up 6% of the shares in Gray's Group. These shares were 'employment-related securities' for the purposes of Chapter 3D of the Income Tax (Earnings and Pensions) Act 2003 ('ITEPA'). When all the shares in Gray's Group were later acquired by a purchaser ('P'), G was entitled under the terms of the subscription agreement to a disproportionately large amount of the price paid – just over £1.4m rather than the £0.4m that would have been the normal value of his 6%. The Revenue determined that the £1m difference ('the £1 million') between these two figures was employment income under the provisions of ITEPA. This meant that it was subject to income tax and national insurance contribution rather than capital gains tax. The Appellant's appeals to the Special Commissioner and to the Court of Session against this determination were dismissed.

JUDGMENT

The Supreme Court, dismissing the appeal, unanimously holds that the £1 million was employment income under Chapter 3D of ITEPA and must be taxed accordingly. The leading judgment was given by Lord Walker. A judgment was also given by Lord Hope. The other Justices sitting agreed with both leading judgments.

REASONS FOR THE JUDGMENT

- The main controversy in the appeal was whether, under the test laid out in s. 446X of ITEPA, the disposal of the shares had been for a price which exceeded the market value of the shares at the time of the disposal [2]. If so, then the excess (less the costs associated with completing the transaction) would be treated as employment income [2]. ITEPA 2003 had adopted the definition of 'market value' set out in capital gains tax legislation [22]. This required consideration of what a hypothetical purchaser would pay to acquire the rights attached to the shares [49]. Two questions emerged: (1) whether G's shares were to be valued simply as shares whose rights were set out in Gray's Group's articles of association, or whether his special rights under the subscription agreement were to be taken into account as if they were set out in the articles and (2) if the latter, what effect those special rights had on the valuation exercise [25].

- The first question could be divided into two parts: (a) whether the special rights should be taken as attaching to the shares as a matter of company law and (b) whether Part 7 of ITEPA, which also dealt with other financial instruments, should be taken as consistently requiring such special rights to be taken into account in the assessment of market value [26].
- On (a), shareholders' mutual obligations were normally set out in the company's articles of association, and Gray's Group's articles said nothing about special rights attaching to G's shares on their disposal [27]. A clause in the subscription agreement did state that the agreement's provisions should prevail over the articles, but there was a previous House of Lords case which suggested that such a provision would have no effect [31]. That case had not been cited in argument before the court, and might require further legal submissions, but was not decisive owing to the conclusions reached on other points [32].
- On (b), elsewhere in Part 7 of ITEPA, in relation to other financial instruments, similar special rights did affect the market value of the asset in question [33]. The principle that tax is to be charged only by clear words was less potent than it had been, but was still relevant to interpreting tax laws. There was real doubt as to whether Parliament, in Part 7 of ITEPA, had enacted a scheme which drew a coherent distinction between the treatment of rights attaching to shares and those attaching to other financial instruments [37].
- The appeal was dismissed on the second question. When P purchased Gray's Group Ltd, it was not concerned with the division of the sale price between the vendors, except in so far as that might have adverse tax consequences for Timber Products [38]. Whether it was right to say that G's special rights did in some sense attach to the shares or not, those rights had no value to the hypothetical purchaser [40, 49]. They were rights personal to G [51] and were extinguished by the payment which G received [50]. The valuation did not have to take account of the actual sale of G's shares at a special price enhanced for reasons relating to G's special position as managing director [43].

NOTE

This summary is provided to assist in understanding the Court's decision. It does not form part of the reasons for the decision. The full judgment of the Court is the only authoritative document. Judgments are public documents and are available at:

www.supremecourt.gov.uk/decided-cases/index.html