Hilary Term
[2010] UKSC 4
On appeal from: [2008] CSIH 11; 2009 SLT 307

JUDGMENT

Grays Timber Products Limited (Appellants) *v* Her Majesty's Revenue and Customs (Respondents) (Scotland)

before

Lord Hope, Deputy President
Lord Rodger
Lord Walker
Lord Brown
Lord Kerr

JUDGMENT GIVEN ON

3 February 2010

Heard on 14 and 15 December 2009

Appellant	*Respondent*
Michael Sherry	David Johnston QC
Alun James	Iain Artis
(Instructed by Biggart Baillie LLP)	(Instructed by HM Revenue and Customs)

LORD WALKER

Introductory

1. In November 1999 Mr Alexander Gibson was appointed as managing director of Grays Timber Products Ltd ("Timber Products"), a wholly-owned subsidiary of Grays Group Ltd ("Group"). He also became a director of Group. He entered into a written service agreement with Timber Products and was also party to a subscription and shareholders' agreement ("the subscription agreement") under which he paid £50,000 to take up ordinary shares (amounting to about 6% of the issued ordinary capital) in Group. In November 2003 all the issued ordinary shares in Group were acquired by an outside purchaser, Jewson Ltd ("Jewson") for £6m, about £5.4m of which was paid in cash. Under the terms of the subscription agreement (to which Group and shareholders owning over four-fifths of its ordinary shares were parties) Mr Gibson became entitled to a disproportionately large part of the consideration paid by Jewson – just over £1.4m, whereas a rateable part would have been just under £0.4m. The issue for the Court is whether the difference between these two sums is (as HM Revenue & Customs –"HMRC" - contend) taxable as employment income of Mr Gibson, subject to income tax and national insurance contribution ("NIC"), or is (as Mr Gibson contends) taxable as a chargeable gain subject to capital gains tax. The claim for income tax and NIC is primarily against Timber Products as Mr Gibson's employer at the time, but if it succeeds the burden will fall on Mr Gibson and others who have covenanted with Jewson to bear those liabilities.

2. That issue depends primarily on the correct construction and application of Chapter 3D of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA 2003") as inserted by the Finance Act 2003, Schedule 22. Chapter 3D consists of only three sections which are, by comparison with other chapters in Part 7 of ITEPA 2003 (as amended), relatively simple and straightforward. They are as follows:

> "CHAPTER 3D – Securities Disposed of for More Than Market Value
>
> "446X Application of this Chapter
>
> This Chapter applies if –

(a) employment-related securities are disposed of by an associated person so that no associated person is any longer beneficially entitled to them, and

(b) the disposal is for a consideration which exceeds the market value of the employment-related securities at the time of the disposal.

446Y Amount treated as income

(1) Where this Chapter applies the amount determined under subsection (3) counts as employment income of the employee for the relevant tax year.

(2) The 'relevant tax year' is the tax year in which the disposal occurs.

(3) The amount is –

$$CD - MV - DA.$$

where –

CD is the amount of the consideration given on the disposal,

MV is the market value of the employment-related securities at the time of the disposal, and

DA is the amount of any expenses incurred in connection with the disposal.

446Z Definitions

(1) In this Chapter 'market value' has the meaning indicated in section 421(1).

(2) For the purposes of this Chapter sections 421(2) and 421A apply for determining the amount of the consideration given for anything.

(3) In this Chapter –

'the employee', and

'employment-related securities',

have the meaning indicated in section 421B(8).

(4) In this Chapter 'associated person' has the meaning indicated in section 421C."

It is common ground that Mr Gibson's shares were "employment-related securities". He was an "associated person" and no issue arises as to any other "associated person". The main area of controversy is "market value", which is defined by reference to the Taxation of Chargeable Gains Act 1992.

3. However Chapter 3D forms part of a complex code with fairly deep and tangled legislative roots. Many of the submissions made on behalf of Timber Products (which has been the appellant at every stage in these proceedings) relied on the need for the expression "market value" to be given a uniform meaning throughout the different chapters comprised in Part 7 of ITEPA 2003. It is therefore appropriate to attempt at least an outline sketch of Chapter 3D's larger context, without going far into complexities which are not directly relevant.

4. Part 7 of ITEPA 2003 is headed "Employment income: income and exemptions relating to securities." Its provisions reflect three different, and to some extent conflicting, legislative purposes. First there is Parliament's recognition that it is good for the economy, and for social cohesion, for employees to own shares in the company for which they work. Various forms of incentive schemes are therefore encouraged by favourable tax treatment (those in force in 2003 are covered in Chapters 6 to 9 inclusive of Part 7).

5. Second, if arrangements of this sort are to act as effective long-term incentives, the benefits which they confer have to be made contingent, in one way or another, on satisfactory performance. This creates a problem because it runs

counter to the general principle that employee benefits are taxable as emoluments only if they can be converted into money, but that if convertible they should be taxed when first acquired. That principle was stated by Lord Radcliffe in *Abbott v Philbin* [1961] AC 352, 379:

> "I think that the conferring of a right of this kind as an incident of service is a profit or perquisite which is taxable as such in the year of receipt, so long as the right itself can fairly be given a monetary value, and it is no more relevant for this purpose whether the option is exercised or not in that year, than it would be if the advantage received were in the form of some tangible form of commercial property."

That was a case about share options, which are now dealt with separately in Chapter 5, but it illustrates the general approach that applied in the days when the taxation of employee benefits was very much simpler than it is now.

6. The principle of taxing an employee as soon as he received a right or opportunity which might or might not prove valuable to him, depending on future events, was an uncertain exercise which might turn out to be unfair either to the individual employee or to the public purse. At first the uncertainty was eased by extra-statutory concessions. But Parliament soon recognised that in many cases the only satisfactory solution was to wait and see, and to charge tax on some "chargeable event" (an expression which recurs throughout Part 7) either instead of, or in addition to, a charge on the employee's original acquisition of rights.

7. That inevitably led to opportunities for tax avoidance. The ingenuity of lawyers and accountants made full use of the "wait and see" principle embodied in these changes in order to find ways of avoiding or reducing the tax charge on a chargeable event, which might be the occasion on which an employee's shares became freely disposable (Chapter 2) or the occasion of the exercise of conversion rights (Chapter 3). The third legislative purpose is to eliminate opportunities for unacceptable tax avoidance. Much of the complication of the provisions in Part 7 (and especially Chapters 3A, 3B, 3C and 3D) is directed to counteracting artificial tax avoidance. There is a further layer of complication in provisions which regulate the inevitable overlaps between different chapters. It is regrettable that ITEPA 2003, which came into force on 6 April 2003 and was intended to rewrite income tax law (as affecting employment and pensions) in plain English, was almost at once overtaken by massive amendments which are in anything but plain English.

8. This case is, it seems, the first case concerned with any of the provisions of Part 7. Timber Products' appeal from a revised determination dated 3 November 2005 was dismissed by a single Special Commissioner (Mr Demack) by a written decision released on 21 March 2007. Timber Products' appeal to an Extra Division of the Inner House of the Court of Session (Lord Kingarth and Lord Mackay of Drumadoon, Lord Osborne dissenting) was dismissed on 13 February 2009. The reasoning of the majority of the Inner House was rather different from that of the Special Commissioner, and counsel for Timber Products has sought to deploy further arguments in this Court.

The subscription agreement and the sale agreement

9. The facts relevant to this appeal are set out in some detail in the decisions of the Special Commissioner and the Inner House (especially the judgment of Lord Osborne). Those decisions are readily accessible, being reported together at [2009] STC 889. I need not therefore add a lot of detail to the brief summary at the beginning of this judgment. But I must give a fuller account of the subscription agreement entered into in 1999 and the sale agreement dated 29 November 2003, especially as they affected Mr Gibson's shares in Group.

10. The subscription agreement was not dated but was signed at different dates between 2 December and 18 December 1999. The parties to it were (1) Group (2) Mr Gibson and (3) Mr J R Nicholson (who owned about 60% of the ordinary shares) and other shareholders who (together with Mr Nicholson) owned about 84% of the ordinary shares. Recital (B) provided:

> "Mr Gibson wishes to subscribe up to 14,465 ordinary shares of £1 each in the share capital of [Group] and [Group] has agreed to issue such shares to him on the terms and conditions set out below."

11. Clause 3 provided for what was to happen to the shares if Mr Gibson's employment ended while he still owned them. If he was dismissed for a serious breach of contract, he was to sell them back to Group for £50,000. If he resigned voluntarily (with no element of constructive dismissal) he was to sell back to Group all his shares for a consideration representing 74% of their net asset value (the net asset value of the whole company being taken to be not less than £1.3m) together with 25% of the amount by which the net asset value (of the whole company) exceeded the "target net asset value" (defined as £1.3m with an indexed escalation of £0.08m for each complete year, but subject to a possible adjustment for newly paid-up preference shares). If Mr Gibson's service terminated in other circumstances (including death or incapacity) clause 3.2.3 provided for all but one

of his shares to be sold back under a similar formula, but with Mr Gibson receiving 50% of the growth in net assets.

12. None of these provisions was put into effect, since Mr Gibson was still in service when Jewson took over Group. But the evident intention that Mr Gibson should participate disproportionately in growth in net assets occurring during his period of service was also reflected in clause 4.2.1, which did take effect on Jewson's takeover of Group more than two years into Mr Gibson's service.

13. Clause 4.2.1 was as follows:

> "In the event of a Shares' Disposal taking place on or after the second anniversary of the Completion Date, Mr Gibson shall sell and the Shareholders shall procure that [Group] or that the purchaser in terms of the Shares' Disposal shall purchase Mr Gibson's Shares at a price equal to the aggregate of the sums calculated in accordance with (i) and (ii) below."

Item (i) was, in the event, £50,000. Item (ii) was one-third of D-(E+F), that is (D) the consideration (£6m) less the total of (E) the target net asset value of the company at the date of the disposal (approximately £1.46m) and (F) item (i) (£0.05m). The total consideration was therefore about £1.5m. HMRC's revised notice of determination proceeded on the basis that this sum exceeded the statutory market value of the shares by £1,059,737, and that the latter sum attracted income tax and NIC. Initially HMRC relied on Chapter 4 of Part 7 of ITEPA 2003, and only later on Chapter 3D, which led to an adjustment as mentioned in paras 1 and 50 of the Special Commissioner's decision. Clause 4.2.2 contained similar provisions applying on a sale of Group's business.

14. Clause 5 provided for Mr Gibson to obtain an additional payment in consideration of his shares if a buy-back took place under clause 3.2.3 and there was a takeover of Group or its business within eighteen months of the buy-back. These provisions were extremely complicated and did not take effect. It is sufficient to say that they reflected the same approach as in clause 4.2.1 and 4.2.2.

15. The underlying purpose of clauses 3.2.2, 3.2.3, 4.2.1, 4.2.2 and 5.2 is set out in clause 6.1:

> "The Shareholders acknowledge and accept that Mr Gibson is to become an executive director of [Timber Products] and shareholder of [Group] on the agreement that, if by reason of his efforts as such

> an executive director, Net Asset Value plus the Notional Goodwill exceeds the Target Net Asset Value on a return of his investment by share buy-back or the Consideration exceeds the Target Net Asset Value on a return of his investment on a sale, he will in certain circumstances and in accordance with clauses 3 and 4 be entitled to an agreed extra payment in addition to the return of his initial investment and, on such a sale, disproportionately greater than the amounts received by other shareholders or *(sic)* his percentage of the equity share capital of [Group]."

Further provisions in clause 6 ensured that these rights were not to be prejudiced by any distribution or reduction of Group's assets.

16. By Clause 7.1 Mr Gibson warranted not to dispose of or encumber any of his shares otherwise than in accordance with the subscription agreement or the articles of Group. Clause 7.3 provided that in the event of a breach of that warranty his service contract and directorships could be terminated. It also provided that this should be "the sole rights or remedies of the Shareholders and [Group] arising from such breach". Clause 9 provided that the agreement, and rights and obligations under it, should not be assignable.

17. By clause 11.1 the agreement was to be governed by the law of Scotland. Clause 11.2 provided:

> "The provisions of this Agreement shall prevail over the Articles (and any other Articles of Association of [Group] subsequently amending or replacing the same) such that if there is any conflict between the two the provisions of this Agreement shall prevail and rule to the exclusion of any such conflicting provisions of the Articles or such other Articles of Association."

18. The subscription agreement provided for Group to adopt new articles of association in a form scheduled to the agreement, and they were duly adopted on 9 December 1999. These provided for the redemption of all the company's A preference shares not later than 31 March 2000. They also referred expressly to the 14,465 ordinary shares to be issued to Mr Gibson (freeing them from pre-emption rights on their issue). They did not however confer any other special rights on these shares. Under para 5(a) and (b) of the articles ordinary shares participated pari passu in income and return of capital.

19. During 2000 Mr Gibson acquired a further 258 ordinary shares under the pre-emption provisions in the articles. These seem to have been accepted as constituting part of "Mr Gibson's shares" for the purposes of the subscription agreement, despite their apparent exclusion under the definition in clause 1.

20. The sale agreement was made on 29 November 2003 between (1) Mr Nicholson, Mr Gibson and five other holders of Group ordinary shares and (2) Jewson. Clause 3.2.1 provided for the cash consideration of £5,403,219 to be paid to the vendors' solicitors as their agents "who are hereby authorised to receive the same whose receipt shall be a complete discharge to the Purchaser who shall not be obliged to enquire as to the distribution thereof". By clause 3.2.2 Elbora Ltd, one of the holders of ordinary shares, was to receive £500,000 loan notes issued by Jewson. Clause 3.2.3 provided for a retention of £96,781. The agreement contained numerous warranties, covenants and indemnities. In particular clause 4A provided for the retention in respect of potential NIC liability, and clause 9 and schedule 9 made further provision for potential PAYE income tax and NIC in respect of Mr Gibson. By clause 3.4 and schedule 1 Mr Gibson was to receive £1,451,172 for his shares. The other shareholders received sums proportionate (as between themselves) to their respective holdings (except that Elbora Ltd received less because of the loan notes).

21. In a disclosure letter dated 29 November 2003 the vendors gave information about the subscription agreement (among other matters). The letter stated, "However, this agreement is to be terminated at completion".

Market Value

22. As already noted, Part 7 of ITEPA 2003 incorporates the statutory definition of "market value" for capital gains tax purposes. That definition is in sections 272 and 273 of the Taxation of Chargeable Gains Act 1992 which are (so far as relevant) as follows:

> "272 Valuation: general
>
> (1) In this Act 'market value' in relation to any assets means the price which those assets might reasonably be expected to fetch on a sale in the open market.
>
> (2) In estimating the market value of any assets no reduction shall be made in the estimate on account of the estimate being made on

the assumption that the whole of the assets is to be placed on the market at one and the same time.

...

273 Unquoted shares and securities

(1) The provisions of subsection (3) below shall have effect in any case where, in relation to an asset to which this section applies, there falls to be determined by virtue of section 272(1) the price which the asset might reasonably be expected to fetch on a sale in the open market.

(2) The assets to which this section applies are shares and securities which are not quoted on a recognised stock exchange at the time as at which their market value for the purposes of tax on chargeable gains falls to be determined.

(3) For the purposes of a determination falling within subsection (1) above, it shall be assumed that, in the open market which is postulated for the purposes of that determination, there is available to any prospective purchaser of the asset in question all the information which a prudent prospective purchaser of the asset might reasonably require if he were proposing to purchase it from a willing vendor by private treaty and at arm's length."

The definition in section 272 can be traced back to section 44 of the Finance Act 1965 and from there to the estate duty valuation provisions in section 7(5) of the Finance Act 1894. Both sides referred to many of the leading cases on the estate duty definition, including *Attorney-General v Jameson* [1905] 2 IR 218, *Salvesen's Trustees v Inland Revenue Comrs* 1930 SLT 387, *Inland Revenue Comrs v Crossman* [1937] AC 26 (in which the House of Lords was divided by three to two) and *Lynall v Inland Revenue Comrs* [1972] AC 680 (in which *Crossman* was challenged but unanimously upheld on the wider issue, but the taxpayer succeeded on the narrower issue as to access to information, so leading to the rule now embodied in section 273 of the 1992 Act). Reference was also made to *Inland Revenue Comrs v Gray* [1994] STC 360, which was concerned with the same definition as used for the purposes of capital transfer tax (now inheritance tax).

23. All these cases, apart from *Gray*, were concerned with the valuation of shares in private companies where the articles contained restrictions on transfer

and rights of pre-emption. There is not, as it seems to me, much difference in the general conclusions which the parties seek to draw from these authorities. It is not therefore necessary to multiply citations. It is sufficient to repeat two passages which were quoted with approval in *Lynall* (by Lord Reid at p 693 and Lord Pearson at p 704 respectively). The first is from the judgment of Holmes LJ in *Jameson* at p 239:

> "The Attorney-General and the defendants agree in saying that in this case there cannot be an actual sale in open market. Therefore, argues the former, we must assume that there is no restriction of any kind on the disposition of the shares and estimate that [sic] would be given therefor by a purchaser, who upon registration would have complete control over them. My objection to this mode of ascertaining the value is that the property bought in the imaginary sale would be a different property from that which Henry Jameson held at the time of his death. The defendants, on the other hand, contend that the only sale possible is a sale at which the highest price would be £100 per share, and that this ought to be the estimated value. My objection is that this estimate is not based on a sale in open market as required by the Act. Being unable to accept either solution, I go back to my own, which is in strict accordance with the language of the section. I assume that there is such a sale of the shares as is contemplated by article 11, the effect of which would be to place the purchaser in the same position as that occupied by Henry Jameson. An expert would have no difficulty in estimating their value on this basis. It would be less than the Crown claims, and more than the defendants offer; but I believe that it would be arrived at in accordance not only with the language of the Act, but with the methods usually employed in valuing property."

24. The second is from the judgment of Lord Fleming in *Salvesen* at p 391:

> "The Act of Parliament requires, however, that the assumed sale, which is to guide the Commissioners in estimating the value, is to take place in the open market. Under these circumstances I think that there is no escape from the conclusion that any restrictions which prevent the shares being sold in an open market must be disregarded so far as the assumed sale under section 7(5) of the Act of 1894 is concerned. But, on the other hand, the terms of that subsection do not require or authorise the Commissioners to disregard such restrictions in considering the nature and value of the subject which the hypothetical buyer acquires at the assumed sale. Though he is deemed to buy in an open and unrestricted market, he buys a share which, after it is transferred to him, is subject to all the conditions in

> the articles of association, including the restrictions on the right of transfer, and this circumstance may affect the price which he would be willing to offer."

25. The importance of identifying precisely the property to be valued was emphasised in *Crossman* (especially by Viscount Hailsham LC at pp 39-40 and Lord Blanesburgh at pp 49-50) and this emphasis is reflected in many of the later cases. It is the first major point of controversy in this appeal: are Mr Gibson's ordinary shares to be valued simply as ordinary shares whose rights are set out in the articles, or are his special rights under clause 4 of the subscription agreement to be taken into account as if they were set out in the articles? (This difference has been described in argument as the difference between "intrinsic" and "extrinsic" rights, and that terminology will serve, at least as shorthand.) The second major point of controversy is: if Mr Gibson's special rights are treated as intrinsic in the shares to be valued, what effect (if any) do they have on the valuation exercise? Are they to be treated as enuring for the benefit of the hypothetical purchaser, or are they to be disregarded as being, even though intrinsic, exclusively personal to Mr Gibson, and worthless to anyone else?

Intrinsic and extrinsic rights

26. The first of these controversies has two strands. One is concerned with shareholder rights as a matter of company law. The other is concerned with the language used in different chapters of Part 7 which, it is argued (especially because of the statute's emphasis on "market value" having the same meaning throughout Part 7) demonstrates that Parliament must have intended to extend the field of relevant material beyond what would conventionally be regarded as intrinsic shareholder rights. This is a difficult and intricate argument and it is probably best to start off with company law (though even that area is not, in this case, without its difficulties)

27. In *Crossman* (at pp 40, 51 and 66) the Lord Chancellor and Lord Blanesburgh (in the majority) and Lord Russell of Killowen (dissenting) all referred to Farwell J's classic definition (in *Borland's Trustee v Steel Bros & Co Ltd* [1901] 1 Ch 279, 288) of a share as consisting partly of mutual obligations entered into by all the shareholders (at the same time Lord Blanesburgh emphasised at p 51 that it is still "one indivisible piece of property"). The shareholders' mutual obligations are normally set out transparently in the articles of association, and Group's new articles (even though adopted in accordance with the subscription agreement) said nothing about special rights attaching to Mr Gibson's shares on their disposal.

28. Mr Sherry (for Timber Products) argued that the rights attaching to shares might be found in arrangements made outside a company's articles. They could be found, he submitted, in a shareholders' agreement or in the terms on which shares were issued. He relied on the observations of Lord Hoffmann in *O'Neill v Phillips* [1999] 1 WLR 1092, 1098:

> "First, a company is an association of persons for an economic purpose, usually entered into with legal advice and some degree of formality. The terms of the association are contained in the articles of association and sometimes in collateral agreements between the shareholders."

Lord Hoffmann also stated at p 1101:

> "But there may be later promises, by words or conduct, which it would be unfair to allow a member to ignore. Nor is it necessary that such promises should be independently enforceable as a matter of contract. A promise may be binding as a matter of justice and equity although for one reason or another (for example, because in favour of a third party) it would not be enforceable in law."

29. Mr Sherry also relied on the decision of the Court of Appeal in *Harman v BML Group Ltd* [1994] 2 BCLC 674. In that case Dillon LJ, in a single extempore judgment with which Leggatt and Henry LJJ agreed, made the general observation (at p 678) that a shareholders' agreement signed by all the shareholders attaching rights to shares must have the same effect as if the rights had been set out as class rights in the articles. But it seems reasonably clear from the report (at p 675) that in that case the division of the share capital into A and B shares, and some of the rights attached to those respective shares, were set out in the articles.

30. In my opinion these passages give Mr Sherry only limited assistance. In *O'Neill v Phillips* Lord Hoffmann was addressing the equitable nature of the court's jurisdiction under section 459 of the Companies Act 1985 to counteract unfair treatment of minority shareholders. He was not addressing the subject of contractual share rights capable of enuring for the benefit of third parties. The context of *Harman v BML Group Ltd* was the court's discretionary jurisdiction under section 371 of the Companies Act 1985 to order the holding of a general meeting. Moreover in the present case not all the shareholders were parties to the subscription agreement.

31. Mr Sherry also placed reliance on clause 11.2 of the subscription agreement, which states that its provisions shall prevail over the articles (and any further articles amending or replacing the current articles). However there is House of Lords authority that a provision in a shareholders' agreement excluding or restricting the company's statutory power to amend its articles is a nullity: *Russell v Northern Bank Development Corpn Ltd* [1992] 1 WLR 588, mentioned by Nigel Doran in (2007) 888 Tax Journal 10. That case concerned an agreement to which the company in question had also been made a party. The House of Lords held that it could take effect only as a personal contract. Lord Jauncey of Tullichettle (with whom the rest of the Appellate Committee agreed), at p 593, quoted Lord Davey in *Welton v Saffery* [1897] AC 299, 331:

> "Of course, individual shareholders may deal with their own interests by contract in such way as they may think fit. But such contracts, whether made by all or some only of the shareholders, would create personal obligations, or an *exceptio personalis* against themselves only, and would not become a regulation of the company, or be binding on the transferees of the parties to it, or upon new or non-assenting shareholders."

32. Unfortunately *Russell v Northern Bank Development Corpn Ltd* was not cited or referred to in the course of argument. It is a decision which has attracted a good deal of discussion as to its extent: see for instance [1992] CLJ 437 (Sealey), [1994] CLJ 343 (Ferran), (1993) 109 LQR 210 (Shapira), 553 (Davenport). If it were likely to be decisive of this appeal, it would not be satisfactory for the Court to decide the case without inviting further written submissions as to its significance.

33. Leaving that strand of Mr Sherry's argument on one side for the present, I come to the other strand, which relies on the use of the expression "market value" in chapters of Part 7 other than Chapter 3D, that is Chapter 2 (restricted securities), Chapter 3 (convertible securities), Chapter 3A (securities with artificially depressed market value) and Chapter 3B (securities with artificially enhanced market value). All these chapters describe the relevant restriction, conversion right or value-shifting mechanism in the most general terms, which would include "extrinsic" arrangements: see sections 423(1)(a), 436, 446A(2) and 446K(2). But they also proceed on the footing that that restriction, conversion right or value-shifting mechanism affects the market value of the securities in question: see sections 428(2), 431(1), 441(6) and (7), 442(5), 446C(2), 446D(1), 446E(3) 446F(4), 446G(1) and (2), 446H(3), 446I(3) and 446L(6). In all these contexts the restriction, conversion right or value-shifting mechanism cannot, it seems to me, be dismissed as something collateral or personal to the particular employee and irrelevant to the valuation.

34. This point was not referred to in the judgments in the Court of Session. Mr Sherry told the Court that it was raised below but as he did not appear in the Court of Session he could not give a detailed account of what happened. Nevertheless it is a point of law which needs to be considered. It is a very puzzling feature of the legislation, and the confusion is increased by the official answers to "frequently asked questions" published by HMRC's predecessor in 2003 (and made available to taxpayers and their advisers until 2005). Question 1(k) and its answer were:

> "Q: Market value is now based on the CGT definition. Does this mean that personal restrictions on the share no longer have to be taken into account in arriving at its value?
>
> A: No. Even where there is, for example, a restriction on sale the shares must be valued as if that restriction would still apply to their hypothetical purchaser. It is the asset (as it is) that is being valued, not some other unrestricted asset."

Question 1(m) and its answer were:

> "Q: The Inland Revenue has confirmed that 'market value' will take into account personal rights and restrictions and not just those rights and restrictions attaching to the shares. Can you confirm that this interpretation of 'market value' will be applied consistently throughout Schedule 22 [to the Finance Act 2003] and that you will not adopt a different interpretation for each Chapter of Part 7?
>
> A: Market value will be determined on a consistent basis throughout Chapters 1 to 5 of Part 7."

Mr Johnston QC (appearing for HMRC in this Court, as he did in the Court of Session) was unable to explain or defend these answers. He said that they were not clear, but to my mind they are perfectly clear – and, on HMRC's case, clearly wrong.

35. In the respondents' printed case Mr Johnston sought to meet the difficulty by submitting that throughout Part 7 "market value" has the same meaning, but that the particular asset being valued is not the same under each chapter. He did not accept that there is any inconsistency in treating extrinsic rights as relevant to valuation under Chapters 2, 3, 3A and 3B but as irrelevant to valuation under Chapter 3D. (Chapter 3C is an exceptional case because the fact that shares are not

fully paid up must be an intrinsic matter: see sections 446Q(3), 446R(2) and 446T(2).)

36. One possible reason for the difficulties in applying Part 7 consistently is the very wide definition of "securities" in section 420(1). It includes not only shares and debentures but also (in paras (c), (d), (f) and (g)) a wide variety of contractual choses in action under financial instruments. Some chapters of Part 7 also refer to interests in securities (defined in section 420(8)). The distinction between intrinsic and extrinsic rights is much less obvious when some of these extended meanings of "securities" are in play. That may help to explain why Part 7 is so difficult, but it does not solve the difficulties.

37. The principle that tax is to be charged only by clear words may be less potent than it was, but it is still relevant to the construction of taxing statutes. I am left in real doubt as to whether Parliament has, in Part 7 of ITEPA 2003, enacted a scheme which draws a coherent and consistent distinction between intrinsic and extrinsic rights attaching to shares and other financial instruments. For that reason I think it unnecessary to invite further submissions on *Russell v Northern Bank Development Corpn Ltd*. But that is not the end of the matter, since some rights, even if properly described as intrinsic to the property to be valued, are nevertheless worthless to the hypothetical purchaser posited by the statutory definition of "market value". So I go on to the second point of controversy, that is whether Mr Gibson's rights under the subscription agreement, even if assumed to be, or treated as, intrinsic, produce the result that Timber Products contends for. It is implicit in that contention that on their acquisition by Jewson each of Mr Gibson's shares had a market value about three times greater than each of the shares owned by the other shareholders.

Standing in the shareholders' shoes

38. That would be a very surprising result. Jewson agreed to buy Group for £6m less a retention, and all the ordinary shares which it acquired were of equal value to it. It was not concerned with the division of the sale price between the vendors (clause 3.2.1 of the sale agreement) except so far as it might involve adverse tax consequences to Group's subsidiary, Timber Products (clause 4A, clause 9 and schedule 9 of the sale agreement). The same would have been true of any other open-market purchaser. Mr Gibson's special rights were peculiar to his position as a director of Group and managing director of Timber Products, as was clearly acknowledged in clause 6.1 of the subscription agreement. His rights were not assignable (clause 9 of the subscription agreement).

39. These rights would have been personal to Mr Gibson even if they had been set out expressly in the new articles adopted by Group when the subscription agreement was entered into. A right can be personal even though it is intrinsic in the sense previously discussed, since class rights can be enjoyed by a class with only one member. Such rights were quite common in the articles of family estate companies formed during the 1930s with a view to saving estate duty. There is an illustration in Dymond's Death Duties, 10th edition (1946) p.61 of a man who owned all the A shares of an estate company, the B shares being held by other members of his family. The A shares were entitled, during his lifetime, to dividends of up to 150% in priority to the B shares; on the deceased's death they became 6% non-participating preference shares. This device was blocked by section 46 of the Finance Act 1940, but until then it avoided estate duty because the A shares had little value on the deceased's death. The Estate Duty Office accepted that the special rights that he had during his lifetime could not be attributed to the hypothetical open-market vendor, and could not benefit the hypothetical open-market purchaser, on the notional sale on the deceased's death posited by section 7(5) of the Finance Act 1894.

40. Mr Sherry argued that Mr Gibson's special rights must be taken into account and treated as enuring for the benefit of the hypothetical vendor. In the Court of Session Lord Osborne accepted that submission (para 46) but I respectfully consider that he went on to undermine his own conclusion when he referred (para 47) to clause 6.1 of the subscription agreement. That clause made it plain that Mr Gibson was to get a special price for his shares, not because the shares themselves had a special value, but in recognition of his personal services as managing director. Lord Kingarth (paras 67 and 68) recognised the significance of clause 6.1 and considered that Mr Gibson's rights were personal rights that did not attach to the shares. Lord Mackay of Drumadoon (paras 87-89) took the same, or a very similar, view. I am in substantial agreement with the majority of the Court of Session, except that I would reach the same conclusion even if the rights did in some sense attach to Mr Gibson's shares: whether attached or unattached, they were of no value to the hypothetical purchaser, and he would pay the hypothetical vendor nothing extra on account of them.

41. Mr Sherry's argument on this point relied on the homely metaphor which judges have often used, of asking what the hypothetical purchaser would pay "to stand in the shoes" of the hypothetical vendor. The first use of this expression seems to have been by Lord Ashbourne C and Fitzgibbon LJ in *Jameson* at pp 227 and 230. The point of the metaphor, I think, is to emphasise that the valuer is concerned with the position of the hypothetical purchaser immediately after the notional sale, rather than worrying about how that sale could take place (perhaps in contravention of the company's articles, which was the real point of dispute in *Jameson*). There is nothing in the speeches to suggest that the hypothetical

purchaser was to be presumed to be a male member of the Jameson family in order to facilitate a transfer under article 18 of the articles of John Jameson & Son Ltd.

42. Mr Sherry also relied on the decision of the Court of Appeal in *Alexander v Inland Revenue Comrs* (1991) 64 TC 59. That was a case about valuation of a flat for the purposes of capital transfer tax on the death of Mrs Alexander. She had bought a flat in the Barbican under the "right to buy" provisions of the Housing Act 1980 at the discounted price of £35,400, representing a discount of £24,600. She died within a year. The flat was (both before and after her death) subject to a charge to repay all or part of the discount if the flat was assigned within five years of its acquisition. This liability would not be triggered by an assent in favour of a beneficiary under the deceased's will or intestacy. Her executor contended for a valuation of £35,400, deducting the full discount. The Inland Revenue's valuer contended for a reduced deduction of about £13,000, reflecting his assessment of the likelihood of an actual sale during the remainder of the five-year period. There was a procedural issue as to whether the matter should be determined by the Lands Tribunal or the Special Commissioners.

43. The Court of Appeal remitted the case to the Lands Tribunal but gave a clear direction as to the valuation principle to be applied. Its decision would have given some support to the appellant if it had directed that the notional sale of Mrs Alexander's flat must for valuation purposes be treated as having triggered an immediate liability for the full £24,600 under the Housing Act charge. But that was not the direction. It was that the notional sale should not be treated as triggering the repayment liability, but that the hypothetical purchaser would be in the position of having to pay off the charge if he made an assignment during the remainder of the five-year period (see Ralph Gibson LJ at pp 70-72 and Nicholls LJ at pp 75-76). The implications of the hypothesis of a sale are not to be taken too far. Ralph Gibson LJ, at p 73, referred to what Lord Guest had said in *In re Sutherland*, decd [1963] AC 235, 262:

> "The purpose of section 7(5) ... is to value the property. 'It does not' as Lord Evershed said 'require you to assume that the sale ... has occurred.' It simply prescribes, as the criterion for value, price in the open market as between a willing seller and a willing buyer, which is a familiar basis for valuation."

Similarly, in this case, the valuation does not have to take account of the actual sale of Mr Gibson's shares at a special price enhanced for reasons related to Mr Gibson's special position as managing director.

44. Mr Sherry asked permission to raise an entirely new argument, set out in para 12 of his printed case, to the effect that the subscription agreement constituted an employment related security in its own right. This argument would have represented a wholly novel approach to the case and would have occupied some time in oral argument. The Court would not have had the benefit of the views of the Court of Session on it. The Court decided that it would not be right to entertain this argument, which seems to fall far short of the test (for admission of an entirely new point on a final appeal) laid down in *Brady v Brady* [1989] AC 755.

45. For these reasons I would dismiss the appeal. I express the hope that Parliament may find time to review the complex and obscure provisions of Part 7 of ITEPA 2003.

LORD HOPE

46. I accept with gratitude Lord Walker's summary of the facts of this case and of the statutory provisions which have given rise to this appeal. As he has said, it is common ground that Mr Gibson's shares were "employment-related securities" within the meaning indicated by section 421B(8) of ITEPA 2003 as inserted by section 140 of and Schedule 22 to the Finance Act 2003, that he was an "associated person" within the meaning indicated in section 421C and that no other associated person was beneficially entitled to those shares after they had been acquired by Jewson. The question is whether his disposal of those shares was for a consideration that exceeded their market value at the time of the disposal, with the result that Chapter 3D of Part 7 of ITEPA 2003 applies to the transaction.

47. The argument in the Inner House of the Court of Session concentrated on the question whether the market value of the shares falls to be assessed by reference to the price that Mr Gibson was entitled to receive for his shares or by reference to the price that Jewson had to pay to acquire them. This, as Lord Walker has explained in paras 25 and 26, is the first point of controversy in this appeal. The second point of controversy, which was not discussed by the judges of the Extra Division in their opinions, was whether the way the concept of market value is dealt with elsewhere in Part 7 of ITEPA 2003 indicates that Mr Gibson's right on a disposal of the shares to a disproportionately large part of the price paid by Jewson must be taken into account in assessing their market value.

48. Mr Sherry for Mr Gibson sought permission to raise a third argument. This was that, if the subscription agreement created rights which were not part and parcel of the shares issued to Mr Gibson, it should be treated as an employment-related security in its own right and that giving effect to its provisions did not give

rise to a payment in excess of its market value for the purposes of Chapter 3D. Mr Sherry said that in the Extra Division Lord Mackay of Drumadoon had in substance adopted this approach: 2009 SLT 307, para 90. It is true that Lord Mackay said there that payment of the enhanced amount to Mr Gibson was the equivalent of the settlement of a debt due under the subscription agreement. But the consequences of that approach were not explored below, and they are not at all easy to determine. The argument that Mr Sherry sought to develop on this point is not one that can properly be raised for the first time in this court.

49. There was a division of opinion in the Inner House on the first question. Lord Osborne said that the formula which was described in clause 4.2.1 of the subscription agreement should be seen as conferring rights on Mr Gibson's shares as regards the payment to be received on their disposal, and that the effect of the sale agreement was that the purchaser specifically agreed with each and every vendor that the payments specified in column (3) of schedule 1 would be made to the appropriate vendor: paras 46-49. I agree with these propositions as far as they go. But I think, with respect, that this approach fails to address the crucial question under section 272 of the Taxation of Chargeable Gains Act 1992 which defines the expression "market value". In estimating the market value attention must be focussed on the asset that requires to be valued. In this case it is the rights attached to the shares acquired by the purchaser, no more and no less. I agree with the majority that what has to be considered, to determine their market value for the purposes of the statute, is what the hypothetical purchaser would pay to acquire those rights at the relevant date: Lord Kingarth at para 59 and Lord Mackay of Drumadoon at para 87. Mr Gibson's right to an enhanced payment had a value to him, but that right was not the subject of the transaction as it did not transmit to the purchaser. What the purchaser acquired and paid for was the rights attached to the shares themselves and nothing else. Mr Gibson's rights under the subscription agreement between him and the other shareholders who were parties to it were given effect when the transaction was entered into, but for the purposes of section 446X of ITEPA 2003 they must be disregarded.

50. Mr Sherry submitted that the rights which Mr Gibson had under the subscription agreement were close enough to being class rights and that, even if that was not so, they attached to the shares for the time being as the terms on which they were issued to him. The fact that the subscription agreement had been approved by a special resolution that was passed at an extraordinary meeting was also significant. The holders of 83.8 per cent of the issued share capital, who were the parties to the subscription agreement, were in a position to secure the passing of that resolution, and it was inevitable that the purchaser would pay Mr Gibson a share of the price which satisfied his entitlement under that agreement. The practical result of these arrangements was that no purchaser would be able to acquire the share capital of the company without seeing that the subscription agreement was satisfied or brought to an end. Attractively put though his argument

was, it seemed to me to miss the point. No doubt Mr Gibson was assured that he would be entitled upon a sale of the company's share capital to the enhanced price that the subscription agreement provided for. But that was, in essence, because of the agreement entered into between him and the other 83.8 per cent shareholders. It was for this reason that the terms agreed with the purchaser extended to how the price was to be divided up between the shareholders. They were designed to give effect to the rights enjoyed by Mr Gibson. But those rights, which were extinguished by the payment which Mr Gibson received, were not part of the assets acquired by the purchaser.

51. The authorities on which Mr Sherry relied did not seem to me to meet this fundamental objection to this part of his argument. In *Attorney-General v Jameson* [1905] 2 IR 218, 226-227 the question was what market value should be attached to shares in a private company on the death of the shareholder. The directors had power under the articles of association to refuse to register a transfer and there was a right of pre-emption in favour of the other members of the company. The argument was that the shares should be deemed to be sold subject to these conditions and restrictions, but it was rejected. The court held that the shares should be valued at the price that they would fetch in the open market on the terms that the purchaser would stand in the shoes of the deceased – in other words, that he would take the shares subject to the restrictions and conditions on transfer in terms of the articles. Mr Sherry said that this reasoning should be extended to the terms on which the shares were issued to Mr Gibson, to reflect their value to the holder of the shares. But the terms on which the shares were issued to Mr Gibson were personal to him. They were not provided for in the articles of association of the company and they were of no interest to a hypothetical purchaser.

52. In *Salvesen's Trustees v Inland Revenue Comrs* 1930 SLT 387, in which the same point was contended for by the taxpayer, Lord Fleming followed the decision in *Attorney-General v Jameson.* As he said at p 391, if the taxpayer was right, it would mean that there could not be a real sale in the open market at all. The shares should be valued at the price which they would fetch if sold in the open market on the terms that the purchaser would be entitled to be registered as the holder of the shares and should take and hold them subject to the provisions in the articles. Those decisions were approved and applied in *Inland Revenue Comrs v Crossman* [1937] AC 26 and the same reasoning was adopted in *In re Lynall, decd* [1972] AC 680. Mr Sherry said that in the light of these decisions and the others mentioned by Lord Walker the hypothetical purchaser must be assumed to have had the benefit of the rights vested in Mr Gibson under the subscription agreement at the time of the transaction, whether or not they were real or personal. But I do not find anything in these cases that supports that approach. It is the terms subject to which the purchaser will take and hold the shares that must be considered. In this case they did not include Mr Gibson's rights under the subscription agreement, as they were extinguished on settlement of the transaction. Their purpose was to enable

Mr Gibson to enhance the benefits available to him in recognition of his services as managing director of Timber Products. That purpose was served when he received the enhanced share of the consideration that he was entitled to. All the shares in Group that Jewson acquired were of equal value to them from and after the date of settlement.

53. Mr Sherry's alternative argument was that the provisions which were substituted by the Finance Act 2003 for those that were originally enacted in ITEPA 2003 were to be read as a code and that the expression "market value" should be applied consistently throughout Part 7. He said that the definitions of "restricted securities" and "restricted interest in securities" for the purposes of Chapter 2 in the substituted section 423 indicated that Parliament must have had in mind that restrictions and conditions outside the articles could affect their market value. This was because section 423(1) provides:

> "For the purposes of this Chapter employment-related securities are restricted securities or a restricted interest in securities if –
>
> (a) there is any contract, agreement, arrangement or condition which makes provision to which any of subsections (2) to (4) applies, and
>
> (b) the market value of the employment-related securities is less than it would be but for that provision."

He drew attention to the width of this definition. Furthermore, the calculation of the amount of the charge under that Chapter that section 428 takes account of what the market value of the employment-related securities would be immediately after the chargeable event but for any restrictions: section 428(2). This provision, said Mr Sherry, indicated that it was to be assumed for the purposes of this calculation that restrictions outside the articles as well as those contained within them could affect market value. He submitted that this approach should be carried forward consistently into Chapters 3, 3A, 3B, 3C and 3D. For example, section 436, which defines "convertible securities" for the purposes of Chapter 3, refers to a contract, agreement, arrangement or condition which makes provision for the conversion of the securities, which must be taken to be something found in the governing instrument and outside the articles. As in Chapter 2, this approach was carried through into the charging provisions under this Chapter: sections 437, 440.

54. He sought to draw support for this reading of the substituted provisions from the answers to the frequently asked questions that Lord Walker has quoted in

para 34. The Finance Act 2003 received the Royal Assent on 10 July 2003 and they were published on or about that date. The key points were that personal restrictions were to be taken into account and that market value would be determined on a consistent basis throughout Chapters 1 to 5 of Part 7. He submitted that post-enactment official statements of that kind could be taken into account as persuasive authority as to the meaning of these provisions: *Bennion, Statutory Interpretation*, 4th ed (2002), section 232; *R v Montila* [2004] UKHL 50, [2004] 1 WLR 3141, para 40; *Chief Constable of Cumbria v Wright* [2006] EWHC 3574 (Admin), [2007] 1 WLR 1407, para 17.

55. But, as Lloyd Jones J said in *Chief Constable of Cumbria v Wright*, para 17, it is for the courts to interpret legislation, not the executive. Mr Johnston QC for the respondents said that the answers on which Mr Sherry sought to rely, which he accepted could not be reconciled with his argument, were not accurate. The point which mattered in this case was that, while the definition of market value was to be applied consistently, the property to be valued under each Chapter varied. The answers had been withdrawn towards the end of 2005 and replaced by a manual dealing with the taxation of employment-related securities from which the points made in the answers were absent. He invited the court not to attach a great deal of weight to them. I agree. I do not think that the points that they make are sufficiently precisely framed to amount to an official statement on the particular issue that arises in this case to carry the persuasive authority that the statement in *Bennion* contemplates.

56. The provisions that are set out in the various Chapters that appear in Part 7 of ITEPA 2003 are complex, and it is not easy to draw conclusions as to how the charging provisions in each Chapter are to be applied if the overall aim is to achieve consistency. I am in any event not persuaded that it would be right to approach these provisions on the basis that the overriding consideration is that each Chapter should be applied consistently with all the others. As the commentator on the Finance Act 2003 in *Current Law Statutes* observed, if there is any theme in the Act it is one of anti-avoidance and the closing down of perceived tax loopholes. This suggests that the correct approach is to take each Chapter according to its own terms without trying to draw conclusions from the way the common definition of "market value" is applied elsewhere in Part 7. I would adopt that approach. It is worth noting too that the interval between the enactment of ITEPA 2003, which received the Royal Assent on 6 March 2003, and the enactment of the Finance Act 2003 was very short. ITEPA 2003 was a product of the "Tax Law Rewrite Project", which was set up specifically to rewrite most direct legislation in user friendly language. It is regrettable that the substituted provisions in the Finance Act 2003 depart from that approach. That, however, was probably inevitable if the Revenue was to achieve the aim of combating tax mitigation planning which is plain from these provisions. As for Chapter 3D, which is the only Chapter with which we need to concern ourselves in this case, it

is as Lord Walker said in para 2 relatively simple and straightforward. I see no escape from the conclusion that the enhanced payment that Mr Gibson received was caught by it and that it is taxable accordingly.

57. For these reasons, and those given by Lord Walker with which I am in full agreement, I would dismiss this appeal and affirm the Extra Division's interlocutor.

LORD RODGER, LORD BROWN AND LORD KERR

58. We are in complete agreement with the judgments of Lord Hope and Lord Walker and, for the reasons that they give, we too would dismiss the appeal.