[2020] UKUT 253 (TCC)

Appeal numbers: UT/2019/0047
UT/2019/0048

INCOME TAX – whether a right to acquire securities arose at time when share option was granted or only when it vested – held when granted – whether shares issued on share-for-share exchange were acquired "as a director or employee" where original shares were so acquired – held yes

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

JOHN CHARMAN	**Appellant/Respondent**
- and -	
THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Respondents/Appellants**

TRIBUNAL: MRS JUSTICE FALK
JUDGE THOMAS SCOTT

Sitting in public by way of video hearing treated as taking place in London on 10 June 2020

Nicola Shaw QC and Michael Jones, instructed by Withers LLP, for Mr Charman

Akash Nawbatt QC and Sebastian Purnell, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for HMRC

DECISION

1. HMRC and Mr Charman each appeal against the decision of the First-tier Tribunal (the "FTT") reported at [2018] UKFTT 765 (TC) ("the Decision").

2. The Decision determined a number of questions concerning Mr Charman's tax residence and his liability to UK taxation on salary, bonuses, restricted shares and share options. With permission of the FTT, HMRC appeal against the FTT's decision as to when certain share options were granted, and Mr Charman appeals against the FTT's decision as to whether certain restricted shares were acquired as a director or employee.

Background

3. In summary, the facts relevant to this appeal are as follows:

(1) Mr Charman was born in the UK. He was employed in the UK until 2001, by which time he was a senior executive in the insurance industry.

(2) In April 2001 Mr Charman began discussions with a US company, MMC Capital Inc ("MMC"), about setting up a new insurance entity in Bermuda. In late November 2001 the new entity, Axis Specialty Limited ("Axis Specialty"), started trading, with Mr Charman as its president and chief executive.

(3) Mr Charman's employment contract with Axis Specialty was dated 20 November 2001. A Share Purchase Option Agreement was appended to his employment contract, under which Mr Charman was awarded options over 253,139 Axis Specialty shares. The options were stated to vest in three equal tranches, on the first, second and third anniversaries of 20 November 2001.

(4) With effect from 19 September 2002, Mr Charman was awarded 50,000 restricted shares in Axis Specialty (the "Axis Specialty Restricted Shares"). The shares were restricted, as discussed further below, until 19 September 2005.

(5) As part of an initial public offering, on 31 December 2002, shares in Axis Specialty were exchanged for shares in Axis Capital Holdings Limited ("Axis Capital"). Under that exchange, Mr Charman and the other shareholders in Axis Specialty exchanged their shares in Axis Specialty for shares in Axis Capital. The shares received by Mr Charman were restricted (the "Axis Capital Restricted Shares"). Following the exchange Mr Charman's shares in Axis Specialty were cancelled.

(6) On 9 January 2003 Mr Charman signed a Notice of Stock Option Grant, stated to be effective as of 1 October 2001. Under that document, Mr Charman was awarded options over 253,139 Axis Specialty shares. The options were expressed to vest in three equal tranches on the first,

second and third anniversaries of 1 October 2001. Although the options were stated to be over shares in Axis Specialty, in fact as a result of changes made to other documents in anticipation of the share-for-share exchange they were over an equivalent number of shares in Axis Capital. We discuss below the apparent duplication between the options granted in November 2001 and those granted with effect from October 2001 under the Notice of Stock Option Grant, but it was common ground that Mr Charman was not awarded options over two lots of shares.

(7) On 30 June 2003 there was a stock split in respect of Axis Capital shares which increased the number of Mr Charman's Restricted Shares to 400,000, and the number of shares over which his share options were exercisable to 2,025,112.

(8) The restrictions on Mr Charman's Axis Capital Restricted Shares were lifted on 19 September 2005, at which point they were worth about $11.5 million.

(9) On 19 and 20 March 2008 Mr Charman exercised some of his share options and sold the shares, realising in total approximately $53 million (and a profit of around $33 million).

(10) HMRC issued various closure notices and discovery assessments. Mr Charman appealed to the FTT against the notices and assessments, including on the ground that he was not resident in the UK at the relevant times.

4. The FTT determined a number of issues. Those which are relevant to this appeal were as follows:

(1) Mr Charman was UK resident until 21 November 2003, and as a result was chargeable to tax on salary, expenses and bonuses received before that date.

(2) Mr Charman did not acquire a "securities option" for the purposes of section 420(8) of Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") until each occasion when a tranche of the options vested. He did not acquire such a right when the options were granted in 2001. This meant that he acquired a securities option when he was UK resident as regards the first two tranches, but when he had ceased to be UK resident as regards the third tranche.

(3) By virtue of section 476 ITEPA, Mr Charman was liable to UK tax when he exercised the options which vested under the first two tranches, even though by then (in 2008) he was no longer UK resident. He was not liable to UK tax on exercise of the options which vested under the third tranche, as a result of section 474(1) ITEPA.

(4) Mr Charman acquired his interest in the Axis Capital Restricted Shares "as a director or employee" for the purposes of Chapter 2 of Part 7 ITEPA, and he was accordingly chargeable to income tax under that chapter when his interest in those shares ceased to be conditional.

5. HMRC appeal against the conclusion at (3) that Mr Charman was not liable to tax in respect of the options which vested under the third tranche, arguing that a right to acquire securities arose when the options were awarded rather than when each tranche subsequently vested. Mr Charman appeals against the conclusion at (4) that the shares in Axis Capital were acquired "as a director or employee", arguing that he acquired his Axis Capital shares in his capacity as a shareholder.

HMRC's Appeal: Share Options

6. It was common ground that Mr Charman acquired "securities options" within ITEPA (whether pursuant to his employment contract in November 2001 or the Notice of Stock Option Grant which took effect from October 2001). It was also common ground that he did so pursuant to a right or opportunity made available by reason of his employment. The issue between the parties is *when* he acquired the securities options. In order to understand why that matters, it is necessary to set out the applicable legislation.

Legislation

7. In October/November 2001, the grant of share options to an employee was governed by section 135 Income and Corporation Taxes Act 1988 ("ICTA 1988"). However, under ICTA 1988 as under ITEPA, the grant of an option was generally not a taxable event; usually, tax arose only in other circumstances such as its exercise. By the time of the option exercise, the relevant provisions were those in ITEPA. It was agreed that in determining Mr Charman's tax position in respect of his share options in this appeal, the relevant legislation is that contained in Part 7 ITEPA, in particular Chapter 5 of Part 7 as substituted with effect from 1 September 2003.[1]

8. At the relevant times, section 420(8) ITEPA defined "securities option" as meaning "a right to acquire securities". "Securities" is widely defined by section 420(1), in terms which would include shares in both Axis Specialty and Axis Capital.

9. The application of Chapter 5 of Part 7 ITEPA is determined by section 471 ITEPA as follows:

> (1) This Chapter applies to a securities option acquired by a person where the right or opportunity to acquire the securities option is available by reason of an employment of that person or any other person.
>
> …
>
> (5) In this Chapter—

[1] See paragraph 10 Schedule 22 Finance Act 2003 and Finance Act 2003, Schedule 22, Paragraph 3(1) (Appointed Day) Order, SI 2003/1997.

> "the acquisition", in relation to an employment-related securities option, means the acquisition of the employment-related securities option pursuant to the right or opportunity available by reason of the employment,
>
> "the employment" means the employment by reason of which the right or opportunity to acquire the employment-related securities option is available ("the employee" and "the employer" being construed accordingly), and
>
> "employment-related securities option" means a securities option to which this Chapter applies.

10. Section 475(1) provides:

> No liability to income tax arises in respect of the acquisition of an employment-related securities option.

11. Instead, the charge to income tax in respect of an employment-related securities option arises under section 476(1), as follows:

> (1) If a chargeable event occurs in relation to an employment-related securities option, the taxable amount counts as employment income of the employee for the relevant tax year.
>
> (2) For this purpose—
>
> (a) "chargeable event" has the meaning given by section 477,
>
> (b) "the taxable amount" is the amount determined under section 478, and
>
> (c) "the relevant tax year" is the tax year in which the chargeable event occurs.

12. "Chargeable event" is defined widely by section 477 in terms which includes an acquisition of shares on exercise of an option. Under section 478 the taxable amount is, broadly, the gain realised, which in this case would be the market value of the shares acquired less the exercise price.

13. In March 2008, when Mr Charman exercised the options, section 474(1) contained an exclusion from the charge under section 476 in the following terms:

> (1) This Chapter (apart from sections 473 and 483) does not apply in relation to an employment-related securities option if, at the time of the acquisition, the earnings from the employment were not (or would not have been if there had been any) general earnings to which section 15 or 21 applies (earnings for year when employee resident and ordinarily resident in the UK).

14. At that time, sections 15 and 21 applied to earnings of an individual who was in that year resident and ordinarily resident in the UK. Thus, Mr Charman's liability to tax on exercise of the options depended on whether he was resident and ordinarily resident in the UK "at the time of the acquisition" of the relevant option. If he was not so resident at that time, then section 474(1) excluded any tax charge on exercise. As we explain above, the FTT's finding (to which there is no

challenge) was that Mr Charman was UK resident until 21 November 2003, but not after that date. Mr Charman says that the FTT were correct to hold that "the time of the acquisition" of the options was when they vested, in three equal tranches in October 2002, 2003 and 2004. On that basis, the exercise of the third tranche of options was not liable to tax, because section 474(1) precluded any liability as Mr Charman was not resident or ordinarily resident in the UK in 2004. HMRC say that is wrong, because all the options were acquired in 2001, with the result that section 474(1) did not apply to exclude liability when any of the options were exercised.

The FTT's decision

15. The same counsel appeared for the parties below. The FTT summarised Ms Shaw's argument regarding the share options as follows:

> 134. According to Ms Shaw, the Share Options are not taxable on Mr Charman because he was not resident at the time when they were acquired in accordance with s 474(1) ITEPA 2003.
>
> 135. The options were granted under the Notice of Option Grant in respect of Axis Capital shares, which superseded the original grant over Axis Specialty shares on 9 January 2003.
>
> 136. On their terms, the vesting of the Share Options is conditional on Mr Charman remaining in employment; at the time when they were granted they do not amount to a "security option" under s 420(8) ITEPA 2003 because of this contingency. Mr Charman has no right to the Share Options, but only a "hope" of receiving them. The right arises only when that contingency is satisfied.
>
> 137. The tax point is when the Share Options vest; Mr Charman was not resident at the time when any of these Share Options vested; the first tranche vested on 20 November 2002, the second tranche on 1 October 2003 and final tranche on 1 October 2004.

16. Mr Nawbatt's submissions were summarised in this way:

> 188. Mr Nawbatt argued that the s 420(8) ITEPA 2003 definition of the "right to acquire shares" is broad enough to cover Mr Charman's Share Options at the date of the original grant. The Share Option Agreement defines the options granted and while these are subject to conditions, a right has nevertheless been granted. Mr Charman acquired a right to acquire shares at the time of the option grant.

17. The FTT preferred Ms Shaw's submissions, setting out its analysis and conclusions as follows:

> 326. The Share Options which were granted to Mr Charman on 20 November 2001 were due to vest in three tranches and were subject to the related Stock Option Agreement. Ms Shaw suggested that it was a condition of the grant of these options that Mr Charman was employed by Axis Specialty at the date when they vested and his rights were to

that extent contingent and so not "rights over shares" for s 420(8) ITEPA 2003 purposes.

327. This is borne out by the Stock Option Agreement, which recognises that options can only be exercised on termination of employment (and subject to various time limits) if they have vested prior to the termination of employment, (unless the termination of employment is due to retirement, when they automatically vest on termination).

328. On this basis we agree that it is accurate to describe the Share Options as contingent on remaining in employment in the sense suggested by Ms Shaw such that no "right to acquire securities" at all arose to Mr Charman until it was clear that he was employed at the date when those rights vested.

329. We have concluded that Mr Charman acquired the rights represented by the Share Options as defined by s 420(8) ITEPA 2003 on the dates when they vested: 1 October 2002, 1 October 2003 and 1 October 2004. Mr Charman's tax residence at each of these vesting dates is therefore relevant by reference to s 474(1) ITEPA 2003; The parties accept that Mr Charman was non-UK resident by 1 October 2004 and we have concluded that Mr Charman was UK tax resident until 21 November 2003.

330. Mr Charman was resident in the UK for tax purposes at the date when the first two tranches of Share Options vested. They therefore do not fall within the scope of the exclusion at s 474(1) because they are employment related securities acquired at the time when Mr Charman was resident in the UK.

Option terms

18. We begin by considering the contractual terms on which Mr Charman was awarded the options, before determining the time at which "a right to acquire securities" arose within section 420(8) under those terms.

19. The parties disagreed as to whether the options exercised by Mr Charman in 2008 were governed by the terms of the Share Purchase Option Agreement appended to his employment contract dated 20 November 2001, or by the Stock Option Grant of 9 January 2003, stated to be effective as of 1 October 2001. Ms Shaw submitted that the latter superseded and replaced the former, while Mr Nawbatt submitted that it merely modified it.

20. The 2003 document does not deal with this question. Nor was there any express finding by the FTT on the point. Both the 2001 Agreement and the 2003 Notice of Stock Option Grant are referred to at [17] of the Decision, but in terms which do not recognise any apparent duplication or conflict between the two. The FTT's discussion appears to refer at [326] and [327] to the 2001 Agreement, but its conclusions (at [329]) refer to the respective 1 October vesting dates, which are those applicable under the 2003 document.

21. Reading the Decision in its entirety, we consider that the FTT must have found that the second and third tranches of the options[2] were governed by the 2003 documents, which superseded the 2001 documents. That was the evidence of Mr Charman before the FTT at paragraph 307 of his Witness Statement, and it appears to have been accepted by the FTT. At [38] the FTT sets out the documentary evidence before it, and in relation to the share options refers at (8) and (9) only to the 2003 Notice of Stock Option Grant (effective 1 October 2001) and the Axis Specialty Nonqualified Stock Option Agreement (which governed the terms on which the options in that notice were granted) (the "Stock Option Agreement"). One of the findings of fact (at [194(10)]) was that "Mr Charman signed his Stock Option Grant in January 2003". Together with the references at [329] to the October 1 vesting dates, we agree with Ms Shaw these passages are consistent only with a finding that the 2003 documents superseded the 2001 documents. We do not consider that to be an unreasonable finding, and our analysis proceeds on that basis.

22. Although the 2003 documents refer to the Axis Specialty Long-Term Equity Compensation Plan, by an amendment document dated 2 December 2002, on consummation of the capital restructuring (which occurred on 31 December 2002) references to Axis Specialty shares were to be interpreted as references to Axis Capital shares.

23. The terms of the Notice of Stock Option Grant dated 9 January 2003 were as follows:

> **Notice of Stock Option Grant**
>
> You (the "Optionee") have been granted the following option to purchase ordinary shares of Axis Specialty Limited (the "Company"), par value $0.10 per share, pursuant to the Axis Specialty Limited Long-Term Equity Compensation Plan (the "Plan"):
>
> Name of Optionee: John Charman
>
> Total Number of Shares Subject to Option: 253,139
>
> Type of Option: Nonqualified Stock Option ("NQSO")
>
> Option Exercise Price Per Share: $100
>
> Effective Date of Grant: 1 October 2001
>
> Vesting Schedule: Subject to earlier vesting pursuant to the terms of the Plan and the attached stock option agreement, provided you are still an employee on such dates, the right to exercise this option shall vest as follows: 1/3 vests on October 1, 2002, 1/3 vests on October 1, 2003, 1/3 vests on October 1, 2004
>
> Expiration Date: October 1, 2011. The Option may expire earlier if employment is terminated.

[2] The first tranche of the options had in fact already vested by January 2003, as those options vested under the 2001 Agreement on 20 November 2002: see [137] of the Decision. It is only the date of acquisition of the third tranche of options which is in dispute in this appeal.

By your signature and the signature of the Company's representative below, you and the Company agree that this option is granted under and governed by the terms and conditions of the Plan and the stock option agreement, both of which are attached to and made a part of this document.

24. The Stock Option Agreement included the following terms:

SECTION 1. GRANT OF OPTION

(a) **Option**. On the terms and conditions set forth in the Notice of Stock Option Grant and this Stock Option Agreement (the "Agreement"), the Company grants to the Optionee on the Effective Date of Grant the option (the "Option") to purchase at the Option Exercise Price the number of Shares set forth in the Notice of Stock Option Grant. The Option is intended to be a Nonqualified Stock Option ("NQSO").

(b) **Plan and Defined Terms**. The Option is granted pursuant to the Plan, a copy of which the Optionee acknowledges having received. The terms and provisions of the Plan are incorporated into this Agreement by this reference…

SECTION 2. RIGHT TO EXERCISE

The Option may be exercised, in whole or in part, to the extent it is vested. The Notice of Stock Option Grant contains the Option vesting schedule. The exercise procedures set forth in Section 6.6 of the Plan shall govern the exercise of the Option.

…

SECTION 4. TERM AND EXPIRATION

(a) **Basic Term**. Subject to earlier termination pursuant to the terms hereof, the Option shall expire on the expiration date set forth in the Notice of Stock Option Grant, which date is 10 years after the Effective Date of Grant.

(b) **Termination of employment**. If the Optionee's employment terminates, the Option shall expire on the earliest of the following occasions:

(i) The expiration date determined pursuant to Subsection 4(a);

(ii) The date three months after the termination of the Optionee's employment for a reason other than Cause (as defined below), death, Disability or Retirement;

(iii) The date one year after the termination of the Optionee's employment due to the death or Disability of the Optionee; or

(iv) The date of the termination of the Optionee's employment for Cause.

The Optionee may exercise all or part of this Option at any time before its expiration under the preceding sentence, but, subject to the following sentence, only to the extent that the Option had become vested (i.e. exercisable) before the Optionee's employment terminated.

> If the Optionee's termination of employment constitutes Retirement, the Option shall become 100% vested and shall remain exercisable until the expiration date determined pursuant to subsection 4(a)…

25. The Axis Specialty Limited Long-Term Equity Compensation Plan (the "Plan") was an overarching document dealing with equity incentives, including both share options and Axis Specialty Restricted Shares. It included the following provisions of particular relevance to this appeal:

> 1.2 **Objectives of the Plan**: the objectives of the Plan are to optimize the profitability and growth of the Company through incentives which are consistent with the Company's goals and which link the personal interests of Participants to those of the Company's shareholders; to provide Participants with an incentive for excellence in individual performance; and to promote teamwork among Participants.
>
> …
>
> 6.1 **Grant of Options**. Subject to the terms and provisions of the Plan, Options may be granted to Participants in such number, and upon such terms, and at any time and from time to time as shall be determined by the Committee.
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> …
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> 6.5 **Exercise of Options**. Options granted under this Article 6 shall be exercisable at such times and be subject to such restrictions and conditions as set forth in the Award Agreement[3] and as the Committee shall in each instance approve, which need not be the same for each grant or for each Participant.
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> …
>
> 6.8 **Nontransferability of Options**
>
> …(b) Nonqualified Stock Options. Except as otherwise provided in a Participant's Award Agreement, no NQSO granted under this Article 6 may be sold, transferred, pledged, assigned, or otherwise alienated or hypothecated, other than by will or by the laws of descent and distribution. Further, except as otherwise provided in a Participant's Award Agreement, during the lifetime of a Participant, all NQSOs granted to such Participant under this Article 6 shall be exercisable only by such Participant.
>
> **Change in Control**
>
> 15.1 **Treatment of Outstanding Awards**. Subject to Section 15.2 hereof, upon the occurrence of a Change in Control, unless otherwise specifically prohibited…(a) any and all Options…granted hereunder shall become immediately exercisable, and shall remain exercisable throughout their entire term…

[3] In this case the Award Agreement would be the Stock Option Agreement.

Submissions of the parties

26. For HMRC, Mr Nawbatt argued that Mr Charman acquired "a right to acquire securities" for the purposes of Chapter 5 of Part 7 ITEPA on the effective date when the options were granted to him, which was in 2001. That was so irrespective of whether the exercise of the right was contingent on him remaining in employment at the dates of vesting of the options.

27. Mr Nawbatt submitted that the legislation is focussed on the date of grant of the option, and it does not refer to the date when any conditions attached to the option are satisfied, or stipulate that the right to acquire securities must be unconditional. This is significant in circumstances where it is common for employee share options to be subject to a contingency that the employee remains in employment at the date of vesting or exercise. This feature of contingency or restrictions designed to incentivise future performance is discussed in *UBS AG v HMRC* [2016] STC 934. In this case, the contingency is a condition precedent to the exercise of the right, but not a condition precedent to the creation of the right to acquire shares. That distinction is supported by the decision in *Inland Revenue Commissioners v Burton Group plc* [1990] STC 242 ("*Burton Group*").

28. For Mr Charman, Ms Shaw contended that the FTT reached the correct conclusion and did so for essentially the right reasons. The legislation does not define what is meant by an "acquisition" of a securities option. It does, however, define what is meant by a "securities option", namely a "right to acquire shares". That means a legal entitlement to acquire shares. The Notice of Stock Option Grant stated that the vesting of "the right to exercise this option" was subject to the proviso that Mr Charman remained in employment at the relevant date. Unless and until that condition was satisfied he had no right to exercise any options. Without such a right, there is no option. As Ms Shaw put it, "the right to exercise the option *is* the right to acquire shares".

29. In Ms Shaw's submission, there is a clear distinction between a right to acquire shares which has been conferred subject to conditions and a right to acquire shares which is to be conferred only if and when certain conditions are fulfilled. The former is a "securities option", an example of which can be found in *Abbott v Philbin* [1961] AC 352. The latter is only a possible future right or chance or possibility to acquire shares, which does not amount to a "securities option" unless and until the conditions are met. An example of the latter is the options granted to Mr Charman. The condition of remaining in employment was a condition precedent to the creation of the right to acquire shares. This distinguished Mr Charman's options from those in *Burton Group,* on which HMRC sought to rely.

Discussion

30. We first analyse the terms of the options granted to Mr Charman, and then consider how the legislation applies in determining when a "right to acquire securities" was acquired under those terms.

31. In her skeleton argument, Ms Shaw submitted that because the options were granted subject to a condition precedent, namely continued employment, no rights were acquired by Mr Charman unless and until that condition was satisfied. In oral argument, that position shifted to the proposition that the grant gave rise to a "chance or possibility " or "possible future right" on the part of Mr Charman, with the grantor company implicitly agreeing not to revoke the agreement under which the option was granted; however, that still fell short of a "right to acquire securities". At a broader level, said Ms Shaw, there was no distinction between a right to exercise and a right to acquire securities within section 420(8), because an option which is not yet exercisable does not constitute a right to acquire securities.

32. The terms of the option are primarily to be found in the Stock Option Agreement and the Plan.[4] Save in so far as those documents incorporate it by reference, the Notice of Stock Option Grant is simply a summary of the rights under those two documents. Under the Stock Option Agreement, the Option is granted, pursuant to the Plan, for a term of ten years unless it has expired earlier. Pursuant to Section 2, the option is exercisable when it has vested in accordance with the schedule in the Notice of Stock Option Grant. The schedule states that the option is exercisable in three tranches on the stated dates "provided you are still an employee on such dates". That wording must be read in light of the Stock Option Agreement, including Section 4 which states that even if an option has not become exercisable before Mr Charman's employment has terminated, it shall become exercisable on his Retirement (as defined in the Plan). Additionally, under Section 15.1 of the Plan, a Change in Control results in all options becoming immediately exercisable regardless of their vesting dates.

33. Considering these contractual terms, we do not accept Ms Shaw's submission that Mr Charman acquired no contractual rights at all unless and until the options became exercisable under their applicable terms. As the documents clearly state, he was granted an option, with an effective date of grant of 1 October 2001.[5] The option was exercisable on the terms and at the times set out. Mr Charman had more than a mere chance or possibility of a right to acquire securities; he had been granted a right to acquire securities, albeit that his ability to exercise that right was conditional. As shown by Section 1.2 of the Plan, the grant was clearly

[4] Both documents are governed by Bermuda law. The FTT heard no expert evidence as to Bermuda law, and we have proceeded on the basis that there are no relevant distinctions from English law.

[5] The parties agreed that this was the effective date of grant of the options, and we proceed below on that basis. It was the date from which Mr Charman worked full time for, and was paid by, Axis Specialty. As far as the documents are concerned, it appears to involve an element of backdating: the earliest date that the documents suggest that a contractual right was actually created was 20 November 2001, the date of Mr Charman's employment contract. An alternative possibility is 9 January 2003 when Mr Charman signed the Notice of Stock Option Grant, but that does not fit easily with the fact that rights were clearly created in some form (over the same number of shares and with the same exercise price) when Mr Charman entered into his employment contract, or with the first tranche having become vested in October 2002. But in any event the differences between the dates are immaterial to this appeal because Mr Charman remained UK resident on each of them.

intended, as with a typical employee share option, to provide a reward and incentive, including an incentive to remain with the company. In relation to the option which is the subject of this appeal, it would have become exercisable (if it had not already vested earlier) on 1 October 2004. If Mr Charman was still employed by the company on (say) 30 September 2004 his right would have had a substantial value. We do not consider that the prohibition on transfer or assignment of the option contained in Section 6.8 of the Plan, which would have prevented him from turning that right to account on 30 September 2004, was included simply to deal with a chance or possibility, but with a significant and potentially valuable right to acquire shares.

34. In our opinion, the terms of the option were such that the right to exercise (which is what was meant by "vesting") was subject to a condition precedent, namely continued employment as defined in the documents, but the grant was not so subject. It was not stated to be a grant subject to a condition precedent, or an agreement to grant Mr Charman an option at a future date, or if he satisfied certain conditions, but a grant.[6] See for example the reference to "You…have been granted" in the Notice of Stock Option Grant, "the Company grants" in section 1(a) of the Stock Option Grant, and the references to options being "granted", and exercisable subject to conditions, in Articles 6.1 and 6.5 of the Plan. As stated in the Notice of Stock Option Grant, it is the "right to exercise" that vests on the 1 October dates, not grant of the option. This is also consistent with the references to the "expiration" of the option, either after 10 years from grant or earlier on termination of employment (section 4 of the Stock Option Agreement).

35. However, the question which falls to be determined is whether the FTT was correct to conclude that Mr Charman only acquired a "securities option" when each tranche of options became exercisable, and not (as HMRC say) on 1 October 2001.

36. Section 477 ITEPA, to which we return below, defines the meaning of "chargeable event" in relation to an employment-related securities option. One such chargeable event is the acquisition of securities pursuant to the option: section 477(3)(a). For this purpose, section 477(4) provides a definition of the date of acquisition of *securities*.[7] However, the statute does not specify when an employment-related securities *option* is acquired. We must therefore approach that question applying the normal rules of statutory construction, and taking into account any applicable case law.

37. Mr Nawbatt relied on the decision in *Burton Group* as demonstrating that a condition attached to a right of exercise did not prevent an option from being

[6] Contrast Clause 5B of Mr Charman's contract of employment, which stated that in the calendar year 2002 he would be "eligible during the Term to receive additional equity grants and awards…all as determined by the Board…in its discretion".

[7] Securities are defined to be acquired at the time when a beneficial interest is acquired (and not, if different, the time when the securities are conveyed or transferred).

acquired. That case concerned amendments to a Revenue approved share option scheme for which Burton Group sought Revenue approval. HMRC refused to approve an amendment which would have permitted the company to set key tasks for a grantee which had to be met before the option became exercisable, where those tasks could be set after the option had been granted. One of the Revenue's objections was that in order for a scheme to be capable of approval under the applicable legislation, an employee must have "obtained a right to acquire shares", and the effect of the amendment sought would be that an employee could not know the terms of acquisition at grant with sufficient certainty, and so would not have obtained a (defined) right to acquire shares. The Special Commissioners rejected that argument, and the High Court (Vinelott J) upheld that decision.

38. The High Court's decision, on what Vinelott J described (at page 257) as "a short and not I think a very difficult question" deals with the issue as follows, at page 260:

> The case for the Crown can be shortly stated. Under s 185(1) a share option scheme if it is to be capable of being approved must be one under which a director or an employee 'obtains a right to acquire shares in a body corporate'. Such an option, if it is to be a valid option conferring rights on the employee, must specify the shares which the employee has the right to acquire or set out a machinery by means of which the shares which he has the right to acquire can be ascertained at the time when the option is exercised. The 1978 scheme without the proposed amendments satisfies these requirements. Any performance conditions or key task conditions must be set out when the option is granted.
>
> I think that is too narrow a view. Under the 1978 scheme with the proposed modifications the employee will be given the right to acquire a number of shares specified in the option. The number may be reduced if performance conditions and key task conditions are not met. It is accepted by the Crown that to the extent that these conditions are set when the option is granted the employee has a right to acquire shares within s 185(1) notwithstanding that the number of shares which he may be entitled to acquire may be diminished by the operation of the conditions. I do not think that it makes any difference that the directors of the company reserve the right to impose new conditions but only in circumstances which are clearly stated and which must be 'reasonably considered ... to be a fair measure of the performance of the holder of the relevant job' and which relate to specified matters, and to vary key tasks if and only if the directors consider that 'a different key task would be a fairer measure of the performance of the holder of the job' and one which 'the Directors reasonably consider will result in any key task in relation to the job being less difficult to satisfy than it would have been without such amendment'. Put shortly, in my judgment it can make no difference that the number of the shares which the employee may be entitled to acquire on the exercise of the option may be governed not only by conditions set when the option is granted but by conditions subsequently imposed or varied but imposed

> or varied in good faith in order to ensure that the scheme operates fairly and effectively as an incentive scheme.

39. The decision in *Burton Group* does not determine the issue in this appeal, because in that case the Revenue accepted that, to the extent that the relevant conditions were set at grant, the employee had a right to acquire shares. However, it is broadly supportive of Mr Nawbatt's submission that the High Court found that an option granted subject to conditions which could operate to reduce the number of shares which could be acquired on exercise nevertheless resulted in the employee acquiring a right to acquire shares. It is also of note that the Special Commissioners rejected the Revenue's argument that the effect of the amendment would be that the grant of the option was subject to a condition precedent, stating as follows (at page 253):

> 13. In my opinion neither the setting of a key task nor the omission to set a key task after the making of an option agreement between the company and an employee is a condition precedent to the creation of a right to acquire shares under the agreement nor is the performance of a key task consideration for the grant of the option. I do not think that [*United Dominions Trust (Commercial) Ltd v Eagle Aircraft Services Ltd* [68] 1 WLR 74] provides an analogy. On the making of the agreement when no key task is specified, the agreement in my opinion operates as the grant of the right to acquire, say, 1000 shares in the company exercisable in due time according to the provisions of the agreement. It will be a term of the agreement that the company may set a key task and if it does the performance of the employee in relation thereto may effect the number of shares he may eventually acquire (just as much as clauses 10A or 10B or 10D may effect the number). But there is no obligation laid on the employee and no promise by him that he will perform the key task. I cannot see how an express right to acquire shares subject to the terms of the agreement (of which one is the company's right to set a key task) can become suspended or transmuted into a possible future right which blossoms into an existing right if a key task is set or is not set. In my opinion the option granted by the company is a binding unilateral contract to which the company may add a term imposing no obligation on an employee but which may or may not affect the number of shares in respect of which he can exercise the right. There is a condition precedent to the exercise of the right (that the employee agrees to subscribe for the shares at the stipulated price)[8]. There is no condition precedent to the grant of the right. The consideration of £1 for the grant of the right under the 1978 scheme is not augmented by any promise by the employee to perform any key task which may be set, whether before or after the agreement is made. There is no such promise in relation to rights granted under seal pursuant to the 1987 scheme.

40. While these comments were made on the facts of the option scheme in *Burton Group*, we consider that, by reference to the options in this appeal, if the

[8] We would comment that it is not strictly correct to describe the obligation to pay the exercise price as a condition precedent.

imposition of a key task on the employee did not create a condition precedent to the acquisition of a right to acquire, it is difficult to see why the imposition of a condition as to continued employment should produce the opposite result.

41. The statutory code governing employee share options contained in Chapter 5 of Part 7 ITEPA, like the predecessor legislation in the Income and Corporation Taxes Act 1988, draws a distinction between the grant of an option and other events, including but not limited to its exercise. The basic rule is that no tax arises when the option is acquired: section 475(1). Instead, taxable employment income arises if a "chargeable event" occurs in relation to the option: section 476. "Chargeable event" is defined by section 477, to include (with exceptions) the acquisition of securities pursuant to the option, assignment of the option or the receipt of some other benefit in connection with the option. Chargeable events are therefore not restricted to the acquisition of securities but cover other forms of derivation of value from the option.

42. The legislative aims of Part 7 were described by Lord Reed in *UBS AG v HMRC* as follows, at [12]:

> [12] Part 7, as amended, was considered by this court in *Grays Timber Products Ltd v Revenue and Customs Comrs* [2010] UKSC 4; [2010] 1 WLR 497. That case concerned Ch 3D of Pt 7, but, in a judgment with which the other members of the court agreed, Lord Walker discussed the wider context. As he explained, the provisions of Pt 7 reflect three different legislative purposes. Those purposes have already become clear from the discussion of the historical background:
>
> > "4. ... 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 ...
> >
> > 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 ...
> >
> > 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 Pt 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 (Ch 2) or the occasion of the exercise of conversion rights (Ch 3). The third legislative purpose is to eliminate opportunities for unacceptable tax avoidance. Much of the complication of the provisions in Pt 7 (and especially Chs 3A, 3B, 3C and 3D) is directed to counteracting artificial tax avoidance."

43. This passage makes it clear that a key philosophy behind the provisions is to "wait and see", by imposing the main tax charge not on the grant of an option but on a subsequent "chargeable event" such as its exercise. The FTT's conclusion that Mr Charman's options were not "securities options" until they became exercisable meant that, in relation to the tranche of options in dispute in this appeal, although effectively granted on 1 October 2001, they did not become "securities options" until 1 October 2004. Two consequences would flow from this which we consider are highly unlikely to have been intended by the draftsman of Chapter 5. The first is that the exemption from grant in section 475(1), reversing the effect of *Abbott v Philbin*, would not have applied to the grant in October 2001,[9] because there had been no "acquisition of an employment-related securities option". The second is that any "chargeable event" occurring between the date of grant and (assuming no early vesting event) 1 October 2004 could not have given rise to a tax charge under sections 476 and 477, because those provisions apply only to chargeable events occurring in relation to an employment-related securities option, which means a "securities option" within section 420(8) to which Chapter 5 applies: section 471(5).

44. In our view, the contractual rights created by the documents amounted to the creation of a "right to acquire securities", and therefore a securities option, at the date they were granted. The language is consistent with the (immediate) creation of a right to acquire shares on a future date, albeit that exercise is subject to a condition in the form of continued employment. Continued employment is not a condition precedent to the creation of any right to acquire shares. There is no agreement to confer a right in the future if a condition is satisfied, and nor is there a promise not to revoke any such agreement: the right exists from the date of grant and would become exercisable (or not) in accordance with its terms, either on the relevant vesting date or, potentially, earlier on retirement or change of control. As already mentioned, the right would have had value prior to vesting, reflecting the incentive that it was intended to create when it was granted.

45. We conclude that, in respect of all three tranches of options, Mr Charman acquired a "securities option" on the effective date of grant specified in the Notice of Stock Option Grant, which was 1 October 2001. The FTT erred in law in reaching the conclusion which it did, and HMRC's appeal succeeds.

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[9] Or whenever the right was actually created: see footnote 5 above.

Mr Charman's Appeal: Restricted Shares

46. Mr Charman appeals against the decision of the FTT that he acquired his interest in the Axis Capital Restricted Shares "as a director or employee". The result of that decision was that Mr Charman was liable to income tax when his interest in those shares ceased to be restricted, in September 2005.

47. The following points were agreed between the parties:

(1) The relevant shares were those in Axis Capital, which were acquired by Mr Charman as a result of the share for share exchange which took place on 31 December 2002.

(2) Mr Charman acquired his interest in the Axis Specialty shares by reason of his office or employment.

(3) The interest in the Axis Capital shares acquired under the exchange was "conditional" within the meaning of the relevant legislation.

(4) That interest ceased to be conditional in September 2005.

Legislation

48. Mr Charman acquired his shares in Axis Specialty in September 2002, and exchanged them for shares in Axis Capital in December 2002. At those times, the applicable tax legislation was contained in sections 140A to 140H ICTA 1988. However, the provisions relevant to this appeal are those contained in the version of ITEPA as originally enacted, which took effect from 6 April 2003.[10] The Decision vacillates between the ICTA and ITEPA regimes in its discussion, but we consider that it is the ITEPA provisions as originally enacted which apply to the issue in this appeal, specifically Chapter 2 of Part 7 of ITEPA, which was entitled "Conditional Interests in Shares". As explained by Lord Reed in *UBS AG v HMRC* at [75], these original provisions of ITEPA were a re-enactment of the ICTA provisions that they replaced, which were introduced in 1988 to prevent the application of *Abbott v Philbin* and forestall tax avoidance.

49. The relevant provisions of ITEPA at that time were as follows:

> **422 Application of this Chapter**
>
> (1) This Chapter applies where—
>
> (a) a person ("the employee") acquires a beneficial interest in shares in a company as a director or employee of that or another company, and
>
> (b) the interest is acquired on terms that make it only conditional.
>
> (2) In this Chapter—

[10] The original provisions in ITEPA were replaced from 1 September 2003 by new provisions introduced by the Finance Act 2003, but only in respect of shares acquired on or after 16 April 2003: paragraph 3(2) Schedule 22 Finance Act 2003. Since the Axis Capital shares were acquired before that date, it is the original provisions of Chapter 2 of Part 7 ITEPA which are applicable in this appeal.

"the employee's interest" means the beneficial interest in shares acquired by the employee as mentioned in subsection (1)

…

423 Interests in shares acquired "as a director or employee"

(1) For the purposes of this Chapter a person ("E") acquires an interest in shares "as a director or employee" of a company if E acquires the interest in pursuance of—

(a) a right conferred on, or opportunity offered to, E by reason of E's office or employment as a director or employee of the company;

(b) a right or opportunity assigned to E, having been conferred on or offered to some other person by reason of E's office or employment as a director or employee of the company; or

(c) an assignment, the interest having been acquired by some other person by reason of E's office or employment as a director or employee of the company.

…

424 Meaning of interest being "only conditional"

(1) For the purposes of this Chapter an interest in shares is "only conditional" for so long as the terms on which the person is entitled to it—

(a) provide that if certain circumstances arise, or do not arise, there will be a transfer, reversion or forfeiture as a result of which that person will cease to be entitled to any beneficial interest in the shares…

…

425 Cases where this Chapter does not apply

(1) This Chapter does not apply where a person acquires a beneficial interest in shares as a director or employee of a company if the earnings from the office or employment in question were not (or would not have been if there had been any) general earnings to which section 15 or 21 applies (earnings for year when employee resident and ordinarily resident in the UK).

…

427 Charge on interest in shares ceasing to be only conditional or on disposal

(1) This section applies if—

(a) the shares cease, without the employee ceasing to have a beneficial interest in them, to be shares in which the employee's interest is only conditional, or

(b) in a case where the shares have not so ceased, the employee sells or otherwise disposes of the employee's interest or any other beneficial interest in the shares.

(2) The taxable amount determined under section 428 counts as employment income of the employee for the relevant tax year.

(3) The "relevant tax year" is the tax year in which the shares cease to be shares in which the employee's interest is only conditional, or in which the sale or other disposal takes place.

…

50. Under section 428, the taxable amount was, broadly, the market value of the employee's interest immediately after the conditions were lifted less certain deductions, in particular the consideration paid for the shares and any amount taxed as earnings on their acquisition.

Relevant facts and documents

51. The background to and circumstances in which Mr Charman acquired his Axis Capital shares were as follows.

52. On 19 September 2002 Mr Charman was awarded 50,000 Axis Specialty Restricted Shares. The shares were ordinary shares but were subject to contractual restrictions as to matters such as transferability, dividends and voting rights. The period of restriction expired on the earliest of 19 September 2005, Mr Charman's retirement or a change in control of Axis Specialty. He acquired the shares pursuant to a Notice of Restricted Stock Award, with an effective date of grant of 19 September 2002 (although the document was not signed by the parties until after that date). The terms and conditions of the award were contained in the Notice, the Restricted Stock Agreement appended to the Notice and the Axis Specialty Limited Long Term Compensation Plan (the "Plan" referred to at [25] above). The Restricted Stock Agreement stated at Article 8(a) that Mr Charman had no rights as a stockholder with respect to any shares subject to the award until all restrictions had lapsed and he had been issued with a share certificate. Article 3(a) provided, inter alia, that the shares could not be alienated during the period that restrictions were in place, and that if Mr Charman's employment terminated for any reason other than retirement prior to the end of the restriction period, then the shares would be immediately forfeited without liability or further obligation on the part of the company. Article 3(b) provided that during the period of restriction dividends would be held by the company and would be payable when the restrictions were lifted.

53. On 2 December 2002 Axis Specialty issued an Offering Memorandum and Information Circular regarding the proposed reorganisation under which it would be acquired by Axis Capital. The documents stated that the reorganisation would be effected as an exchange if 100% of Axis Specialty shares were tendered in the

offer, and as a merger if not. In the event, the reorganisation was effected as an exchange, under which shares in Axis Capital were issued in exchange for shares in Axis Specialty on a one-for-one basis. The Offering Memorandum set out the benefits of the reorganisation as an increase in access to capital and a more flexible business structure. It was explained that Axis Capital would be managed by the same board of directors as the then board of Axis Specialty. The reorganisation was described to shareholders as follows:

> Axis Specialty…is pleased to report that its board of directors has approved the recapitalization of Axis Specialty, which will be accomplished through the formation of a holding company structure with Axis Capital Holdings Limited, a Bermuda company (Axis Holdings) becoming the new holding company. Upon consummation of the proposed recapitalization, Axis Specialty would become a wholly-owned subsidiary of Axis Holdings, and the current shareholders of Axis Specialty would become the shareholders of Axis Holdings. Additionally, in connection with these transactions Axis Specialty intends to distribute the stock of its first tier subsidiaries to Axis Holdings…as a result of which the first tier subsidiaries would become wholly-owned subsidiaries of Axis Holdings…

54. As explained at [22] above, the Plan was amended on consummation of the recapitalisation transaction, broadly to take effect in relation to existing awards as if references to Axis Specialty shares were to Axis Capital shares. The amendments also had the effect that holders of Restricted Shares would not be precluded from participating in the share-for-share exchange. On 14 March 2003 an Axis Capital 2003 Long-Term Equity Compensation Plan was introduced. The objectives of the Axis Capital Plan (Article 1.2) mirrored those of the Axis Specialty Plan (see [25] above). Article 8 largely repeated the provisions in the Axis Specialty Plan in relation to awards of Restricted Stock. Article 19.1 provided that the Axis Specialty Plan would be subsumed into the new plan, and that outstanding awards under the Axis Specialty Plan would be "subject to (a) the terms and conditions of the existing Award Agreements pursuant to which they were granted and (b) the terms and conditions applicable to Awards granted under this Plan". The relevant Award Agreement in this case was the Restricted Stock Agreement referred to at [52] above.

55. Under the reorganisation, Mr Charman and all the other shareholders of Axis Specialty exchanged their shares for shares in Axis Capital. Mr Charman's Axis Capital shares were, as explained above, subject to the same contractual restrictions as his Axis Specialty shares. Mr Charman's Axis Specialty shares were cancelled following the exchange.

56. On 30 June 2003 there was a stock split in respect of Axis Capital shares which increased the number of Mr Charman's Restricted Shares to 400,000.

57. The restrictions on Mr Charman's Axis Capital shares were lifted on 19 September 2005.

The FTT's Decision

58. Before the FTT, HMRC pursued a number of arguments in relation to the Restricted Shares which are not relevant to this appeal. In relation to the issue in this appeal, namely whether Mr Charman acquired his shares in Axis Capital "as a director or employee", the parties disagreed as to the reasons for the FTT's decision. We return to this below, but it is helpful to set out the relevant passage, as follows:

> 312. We do not agree with the Appellant that the share for share exchange changed the source of the income arising to Mr Charman for tax purposes. Despite the fact that Mr Charman ended up holding shares in Axis Capital, in our view that holding arose from his employment through the original shares in Axis Specialty and s 140A (1) ICTA 1988 applies to the Restricted Shares.
>
> 313. The Appellant relied on the *Abbot v Philbin* and *Wilcock v Eve* cases but we consider that these cases can easily be distinguished because:
>
> (1) They consider tax arising on the exercise of share options, which, for common law purposes, is accepted as having a source other than employment; being the extraneous factors which have impacted the value of the shares underlying the option.
>
> (2) We accept that these cases suggest the need for a relatively tight nexus between the sum received and the employment which gave rise to that sum, but this is in part because the question asked in those cases is whether the value which is giving rise to the tax (the gain on the exercise of the option) derives from the employment, to which the answer is no. That is not the case for the shares which Mr Charman received as part of the share for share exchange which merely represent a change in form of an existing asset (the Axis Specialty shares) into another asset (the Axis Capital shares) of the same economic value.
>
> (3) It is accepted that "borderline cases" are likely to be difficult because there is more than one operative cause of the taxable income; that is the case here, but in our view the ultimate cause (or source) is Mr Charman's employment with Axis Specialty.
>
> 314. To suggest that a share for share exchange can break the nexus between shares which are emoluments and turn them into shares which are derived from a different source seems to us an overly mechanistic approach to the law, and to result in a rather surprising conclusion which provides a very ready loophole for anyone wishing to avoid tax on their employee shares.
>
> 315. The point was succinctly put in *Wilcock v Eve* referring back to the judgment of Neill LJ
>
> "The question is, was the payment an emolument from the employment? In other words, was the employment the source of the emolument" [p14]
>
> In our view the only realistic response to this question in respect of the Axis Capital shares in [*sic*] yes.

> 316. Our approach is supported by the Offering Memorandum and the amendments to the Share Scheme Plans which were consequent on the re-capitalisation. The share for share exchange was carried out under Bermuda law and envisaged, in the Offering Memorandum, that it could be achieved either by way of exchange or by way of merger. Ms Shaw pointed to the provisions in the Offering Memorandum which said that the Axis Specialty shares were cancelled to support her position, but we note that this was only stated to be the case in respect of the merger, there is no equivalent statement in respect of a share exchange.
>
> 317. We considered whether we should ask for a more detailed analysis of how the re-capitalisation had taken place by reference to Bermuda law but concluded that this was not necessary. We did see the copy share ledger of Axis Speciality stating that Mr Charman's shares in Axis Specialty had been cancelled on 31 December 2002. Despite the fact that the Axis Specialty shares were cancelled on or immediately after the exchange or merger, that does not in our view mean that Mr Charman has divested himself of his rights as an employee to shares; those rights were represented initially in the form of the Axis Specialty shares and as a result of the re-capitalisation have changed form to become rights to the Axis Capital shares, but only in a very formalistic sense have Mr Charman's rights been altered. In our view the essential purpose of a merger or share for share exchange is to ensure that existing shareholder rights are changed in form but not in substance, as reflected by the usual UK tax treatment of such transactions (which as Mr Nawbatt pointed out, is referred to in the Offering Memorandum).

Submissions of the parties

59. Ms Shaw submitted that the FTT erred in law in reaching this conclusion, because Mr Charman acquired his shares in Axis Capital not by reason of his employment with Axis Specialty, but by reason of his status as a shareholder in Axis Specialty. The correct approach to determining the source of his Axis Capital shares is that set out in *Abbott v Philbin* and *Wilcock (Inspector of Taxes) v Eve* [1995] STC 18. The FTT erred in distinguishing those two cases, and took the approach advocated by Lord Denning in *Wicks v Firth* [1982] Ch 355, which is no longer good law: see the decision of the Court of Appeal in Northern Ireland in *Mairs v Haughey* [1992] STC 495. HMRC's approach was also to say that the shares must have been acquired by reason of employment if they could not have been acquired "but for" Mr Charman remaining an employee and thereby retaining his Axis Specialty shares. Asking the question posed in *Mairs* and *Wilcock*, namely what enabled Mr Charman to acquire his shares in Axis Capital, the answer was his shareholding in Axis Specialty. He would not have acquired the Axis Capital shares if he had been an employee of, but not a shareholder in, Axis Specialty. The other shareholders in Axis Specialty also received shares in Axis Capital, even though they were not employees. *Abbott v Philbin* showed that the fact Mr Charman originally received his Axis Specialty shares by reason of employment, and indeed had to be an employee to acquire the Axis Capital Restricted Shares, made no difference.

60. The FTT was also wrong, said Ms Shaw, to consider that the analysis contended for by Mr Charman gave rise to a ready loophole for anyone wishing to avoid tax on employee shares. There is a tax charge under the code when an employee disposes of restricted shares, and the share-for-share exchange was a disposal for these purposes.

61. Finally, Ms Shaw pointed out that ITEPA was subsequently amended by the Finance Act 2003 to deem shares acquired under a share-for-share exchange to have been acquired pursuant to the same right or opportunity as the original shares. If the FTT were correct, then this change would have been otiose.

62. For HMRC, Mr Nawbatt said that the FTT were correct, and applied a purposive construction to the legislation, in holding that Mr Charman's contention involved an overly mechanistic approach to the law and facts which could not have been intended by Parliament. Viewed realistically, the Axis Capital shares merely represented a change in the form of an existing asset (the Axis Specialty shares) into another asset (the Axis Capital shares) of the same economic value and subject to the same employment-related terms, conditions and restrictions. Mr Charman's beneficial interest in the shares of both companies was inextricably linked to and grounded in his employment. If he had not been an employee at the time of the exchange, his interest in the Axis Specialty shares would have lapsed and he could not have participated in the exchange. The FTT was correct to distinguish *Abbott* and *Wilcock*, as those cases concerned different issues.

63. As to the loophole argument, it was correct that there would have been a charge under the statute when the shares were exchanged, but the subsequent charge applying (on the FTT's analysis) when the restrictions on the Axis Capital shares were lifted would have given credit for that charge. The purpose of the legislation, which Mr Charman's analysis would frustrate, is to tax the true economic benefit, which is realised not on the exchange but when the restrictions are lifted.

64. The amendments made by the Finance Act 2003 were not otiose, but simply clarified the law.

The case law

65. The central argument raised by Mr Charman in this appeal is that the FTT misdirected itself as to the law and thereby wrongly approached the question of whether his Axis Capital shares were acquired "as a director or employee". The parties disagree as to the effect of the case law in relation to that question. In particular, we heard extensive submissions in relation to *Wicks v Firth*, *Abbott v Philbin*, *Wilcock v Eve* and *Mairs v Haughey*. We also heard argument in relation to *Kuehne & Nagel Drinks Logistics Ltd v HMRC* [2012] STC 840 and *Vermilion Holdings Ltd v HMRC* [2020] UKUT 0162 (TCC).

66. We therefore begin by reviewing those authorities, in chronological order, before turning to the FTT decision and its reasoning. It should be noted at the outset that the question in this appeal, by virtue of section 423 ITEPA, is whether or not Mr Charman's Axis Capital shares were acquired "in pursuance of a right conferred on, or opportunity offered to, [him] by reason of [his] office or employment". The question is not whether those shares were emoluments "from" his employment, which was the issue in *Abbott v Philbin* and *Kuehne*. *Wilcock v Eve* and *Mairs v Haughey* concerned both questions. We discuss below the extent to which the two tests are different.

67. In *Abbott v Philbin* the issue before the House of Lords was whether the exercise of a share option was taxable as an emolument from an employment. It was held by a majority (Lord Keith and Lord Denning dissenting) that the taxpayer had been liable to tax in the year when the option was granted, on its then monetary value, but was not liable to income tax on the profit on its subsequent exercise. The ratio of the decision was largely reversed by subsequent legislation, as we have seen in the discussion of HMRC's appeal on the option issue, but for the purposes of this appeal the discussion by the court of the nature and source of any benefit remains relevant.

68. The option in *Abbott* was granted in 1954, giving the employee, for a price of £20, an option to purchase 2,000 shares at the price of 68s 6d per share, such option to be exercisable at any time within 10 years of grant. The option was expressed to be non-transferable and to expire on the death or retirement of the employee before the expiration of 10 years. In 1956, the price of the company's shares having risen to 82s, he exercised his option in respect of 250 of the shares. The Inland Revenue assessed him to income tax on the market value of the shares on exercise less the £20 and the exercise price, as being a perquisite or profit "from" his employment.

69. Viscount Simonds described as "the curious feature of this case" that the Revenue denied that the option was taxable on grant, having accepted that if it were taxable on grant then its subsequent exercise could not be taxable (page 365). Viscount Simonds described the absence of a tax liability on grant as "an impossible proposition", since the option at grant had a value or potential value and could be turned to pecuniary account (page 367). Therefore, said Viscount Simonds, the Revenue's case "fails at the initial step". He went on to observe that their case also failed because the profit on exercise did not arise from the employment but from other factors, as follows (at page 367):

> But I do not find it easy to say that the increased difference between the option price and the market price in 1956 or, it might be, in 1964 in any sense arises from the office. It will be due to numerous factors which have no relation to the office of the employee, or to his employment in it. The contrast is plain between the realised value, as it has been called, of the option when the shares are taken up (though the realisation falls short of money in hand) and the value of the option when it is granted. For the latter is nothing else than the reward for services rendered or, it may be, an incentive to future services. Unlike

> the realised value it owes nothing to the adventitious prosperity of the company in later years. On this ground also I should reject the claim of the Crown.

70. Lord Radcliffe also considered that, in determining whether the option should be taxed on grant or on exercise, taxation at grant was both justified and avoided anomalies. He explained why the subsequent exercise of the option would not be taxable in the following terms (at page 379):

> The claim to tax the advantage obtained in the year 1955-56 is not claimed by the Revenue if the right view is that the option itself was taxable in 1954-55. Even if there were no taxable subject in the earlier years I should regard the 1955-56 claim as failing on its own terms. The advantage which arose by the exercise of the option, say £166, was not a perquisite or profit from the office during the year of assessment: it was an advantage which accrued to the appellant as the holder of a legal right which he had obtained in an earlier year, and which he exercised as option holder against the company. The quantum of the benefit, which is the alleged taxable receipt, is not in such circumstances the profit of the service: it is the profit of his exploitation of a valuable right. Of course, in this case the year of acquiring the option was only the year immediately preceding the year in which, pro tanto, it was exercised. But supposing that he holds the option for, say, nine years before exercise? The current market value of the company's shares may have changed out of all recognition in that time, through retention of profits, expansion of business, changes in the nature of the business, even changes in the market conditions or the current rate of interest or yield. I think that it would be quite wrong to tax whatever advantages the option holder may obtain through the judicious exercise of his option rights in this way as if they were profits or perquisites from his office arising in the year when he calls the shares.

71. The Court of Appeal decision in *Wicks v Firth* contained the first judicial discussion of the provisions introduced in 1976 to tax benefits received "by reason of employment".[11] In that case, ICI executed a trust deed settling funds on trustees to make discretionary awards to the children of employees of the company to assist them in further education. One of the issues was whether the taxpayer, who was an employee of the company, was liable to income tax on the basis that an award received by his child was made "by reason of his [the taxpayer's] employment".

72. Lord Denning stated as follows (at pages 363-364):

> *"By reason of his employment"*
>
> It seems to me that the words "by reason of" are far wider than the word "therefrom" in section 181 (1) of the Income and Corporation Taxes Act 1970. They are deliberately designed to close the gap in

[11] The House of Lords (Lord Templeman dissenting) reversed the Court of Appeal on other grounds ([1983] 2 AC 214), declining to express a view on the issue of "by reason of employment".

> taxability which was left by the House of Lords in *Hochstrasser v. Mayes* [1960] A.C. 376. The words cover cases where the fact of employment is the causa sine qua non of the fringe benefits, that is, where the employee would not have received fringe benefits unless he had been an employee. The fact of employment must be one of the causes of the benefit being provided, but it need not be the sole cause, or even the dominant cause. It is sufficient if the employment was an operative cause - in the sense that it was a condition of the benefit being granted. In this case the fact of the father being employed by ICI was a condition of the student being eligible for an award. There were other conditions also, such as that the student had sufficient educational attainments and had a place at a university. But still, if the father's employment was one of the conditions, that is sufficient. If two students at a university were talking to one another - both of equal attainments in equal need - and the one asked the other "Why do you get this scholarship and not me?" He would say "Because my father is employed by ICI." That is enough. The scholarship was provided for the son "by reason of" the father's employment.

73. Oliver LJ considered and also rejected the argument of counsel for the taxpayer that “by reason of” should be given the same construction as “from”. However, he formulated the “by reason of” test differently to Lord Denning, in the following terms (at pages 370-371):

> Speaking only for myself I do not, in the case of this legislation, find the philosophical distinction between a "causa causans" and a "causa sine qua non" helpful. I see no reason why a benefit "derived" from the employment (to use the words of the chapter title) necessarily has to be invested with an intention on the part of the employer to remunerate the employee for the performance of his duties. One is directed to see whether the benefit is provided by reason of the employment and in the context of these provisions that, in my judgment, involves no more than asking the question "what is it that enables the person concerned to enjoy the benefit?" without the necessity for too sophisticated an analysis of the operative reasons why that person may have been prompted to apply for the benefit or to avail himself of it.

74. Earlier, at page 369, Oliver LJ had also made clear that the test is not whether the benefit is provided “by reason *only*” of employment, and at page 370 that the intention of the legislation was to tax the value of otherwise untaxed advantages enjoyed by an employee “because he is employed”.

75. Watkins LJ endorsed Lord Denning’s view on the meaning of “by reason of employment” (at page 372):

> I have been greatly assisted in reaching this conclusion by the construction put upon section 61 by Lord Denning M.R., with which in every respect I entirely agree.

76. We turn next to the decision of the Court of Appeal in Northern Ireland in *Mairs v Haughey*.[12] On the privatisation of Harland and Wolff in 1989, the employees were offered new employment by a "buy-out" company as an alternative to redundancy. The new contracts would not include the benefit of the enhanced redundancy scheme that had previously been available. Under the offer, each employee would receive an ex gratia payment calculated as the aggregate of (a) a percentage of the sum to which he would have been entitled under the old redundancy scheme, and (b) a sum for each year of past service. Mr Haughey accepted the offer, and was assessed to income tax on the entire payment. The Special Commissioner decided that it was appropriate to apportion the payment between the two elements, and to treat (a) as compensation for the loss of contingent rights under the old redundancy scheme and (b) as consideration for the acceptance of the new terms and conditions of the replacement employment. On that basis the Special Commissioner held that element (a) was taxable neither as an emolument "from" employment nor as a benefit received by reason of employment. The Revenue appealed, arguing in the alternative that the payment should not have been apportioned, and that if that was wrong, element (a) was both an emolument and a taxable benefit.

77. The Court of Appeal held that the Special Commissioner had been right to apportion the payment, and that element (a) was neither an emolument nor a taxable benefit. In relation to the question of whether element (a) was "from" employment, Hutton LCJ considered whether a payment under the enhanced redundancy scheme would itself have been taxable as an emolument, such that compensation for the extinction of the right was also so taxable. He referred to the judgments of Lord Radcliffe and Viscount Simonds in *Hochstrasser v Mayes* [1960] AC 376, Lord Hodson in *Laidler v Perry* [1966] AC 16 and Lord Templeman in *Shilton v Wilmshurst* [1991] AC 684, and concluded as follows (at pages 519-520):

> Following the guidance contained in those judgments I am of opinion that a payment made under the scheme was not, in law, taxable under Sch E as an emolument 'from' employment. A person would not have received the payment unless he had been an employee of Harland and Wolff but, as Lord Radcliffe stated, that is not sufficient to render the payment assessable. I consider, if I may adopt the words of Lord Radcliffe, that the payment would not have been made to him 'in return for acting as or being an employee'; on the contrary, I think that the payment would have been made to him because he was ceasing to be an employee and to cushion him against the hardship of losing his employment…
>
> Applying the test stated by Viscount Simonds, and approved by Lord Hodson, I consider that employment by Harland and Wolff would only have been the causa sine qua non of the redundancy payment, and not

[12] Decisions of the Court of Appeal in Northern Ireland relating to statutes which apply in England and Wales ought to be followed to prevent undesirable inconsistency: *Deane v Secretary of State for Work and Pensions* [2011] 1 WLR 743 at [26].

> the causa causans. In my opinion the causa causans would have been the redundancy.
>
> …
>
> Accordingly, as I consider that a redundancy payment would not have been an emolument 'from' employment, I further consider that compensation for the loss of the contingent right to receive such a payment is not taxable as an emolument 'from' employment. In my opinion, if the receipt of such a payment does not constitute an emolument 'from' employment, the receipt of a sum paid to compensate for the loss of the contingent right to receive that payment cannot itself constitute an emolument 'from' employment.

78. In relation to the Special Commissioner's conclusion that the redundancy related payment was not a benefit received "by reason of employment", Hutton LCJ referred to the Commissioner's citation of the formulations set out by Lord Denning and Oliver LJ in *Wicks v Firth*. In a passage relied on by Ms Shaw he then stated as follows (at page 525):

> I prefer, with respect, the test suggested by Oliver LJ, which involves asking the question 'What is it that enables the person concerned to enjoy the benefit?' than the causa sine qua non test suggested by Lord Denning. I respectfully agree with Lord Denning and Oliver LJ that the words 'by reason of' in s 154 are wider than the word 'therefrom' in s 19(1). It also follows that if one does not apply to s 154 the causa causans test approved by the House of Lords in relation to s 19(1), a causa sine qua non may constitute a 'reason' for the provision of a benefit. But I consider, with respect, that the causa sine qua non test suggested by Lord Denning is too wide and could let in a factor in the past which, in ordinary language, would not constitute a 'reason' for the provision of the benefit. It is appropriate to recall the warning given by Lord Radcliffe in *Hochstrasser v Mayes* [1960] AC 376 at 391, 38 TC 673 at 707 that, whilst explanations by eminent judges of the meaning of particular words are valuable, they do not displace the words themselves. Neill LJ gave the same warning in *Hamblett v Godfrey* [1987] STC 60 at 71, [1987] 1 WLR 357 at 370 when he said—'... one must never lose sight of the fact that these explanations cannot provide a substitute for the statutory words'.
>
> Whilst in this case the question which arises in respect of the words 'by reason of' is not an easy one to answer, I consider that the payment was not received by the taxpayer 'by reason of' his employment with Harland and Wolff. Asking the question posed by Oliver LJ 'What is it that enables the person concerned to enjoy the benefit?', I would answer 'The surrender by the taxpayer of his contingent right to receive a payment from the scheme', and I would not answer 'His employment with Harland and Wolff'.
>
> Adapting the question posed by Lord Denning at the end of the passage of his judgment I have cited, if the taxpayer and a friend employed by another engineering company were talking to one another and the friend asked the taxpayer 'Why did you receive a payment of £4,506 and not me?' I consider that the taxpayer would answer 'Because I gave

> up my right to get a payment if I became redundant' and would not answer 'Because I am employed by the new Harland and Wolff company'. Therefore I would differ from the Special Commissioner on the first question.

79. The Revenue's appeal against the Court of Appeal's decision was dismissed by the House of Lords ([1994] 1 AC 303) without further consideration of *Wicks v Firth*. Lord Woolf, who delivered the only substantive judgment, commented as follows in relation to the determination of whether a receipt was an emolument "from" employment (at page 320):

> However, this is an area in which there is an abundance of authority. It is not always easy to reconcile these authorities since as is to be expected they are frequently concerned with situations close to the borderline between payments which fall within and payments that fall without the statutory provision. It is possible to have almost an infinite variety of situations which, although they have common characteristics, as a matter of fact and degree fall on one side of the border or the other. In each case ultimately it is a matter of applying the statutory language to the facts. However, general assistance is provided by the speeches in *Hochstrasser v. Mayes* [1960] A.C. 376 and *Shilton v. Wilmshurst* [1991] 1 A.C. 684. In the former case I find the passage in the speech of Lord Radcliffe, at pp. 391-392, of help where he said of the statutory language:
>
> > "For my part, I think that their meaning is adequately conveyed by saying that, while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as or being an employee."

80. *Wilcock v Eve* was a decision of the High Court (Carnwath J, as he then was). Following a management buy-out of a company, the taxpayer's share options in the company's parent company lapsed under the terms of the scheme. It was found as a fact that the parent company made him an ex gratia payment because it wished to maintain its reputation of dealing fairly with its employees and ex-employees. The Inland Revenue assessed him to tax on the payment, on the basis that it was an emolument, or alternatively that it was a benefit received by reason of employment.

81. On the basis of *Abbott v Philbin* and other authorities, the court held that since the grant but not the exercise of an option is an emolument, a payment in recognition of the loss of a right to exercise was not an emolument.[13] In reviewing the statements in the leading cases on the "from" issue, Carnwath J observed, at page 25:

> Without any desire to diminish the undoubted authority of those statements, it must be recognised that in most of these borderline cases the problem is that there is more than one operative cause for the

[13] Such a payment may now be chargeable under section 477 ITEPA.

> payment. Inevitably, there is an element of value judgment in deciding on which side of the statutory line the payment falls.

82. He commented further (at page 26) on the contrasting outcomes in some of the cases:

> One sees the essential contrast between rights intimately linked with employment and rights enjoyed in some other capacity.

83. The court framed the question on this issue as whether the loss of rights under the share option scheme was "intimately connected with the employment", or alternatively as something distinct (page 27). Carnwath J said that he would have seen this as very much a borderline question but for the decision in *Abbott v Philbin*. In reliance on the passage in Viscount Simonds' judgment set out at paragraph [69] above, the value realised on exercise of an option could not (prior to the legislative changes which reversed the effect of *Abbott*) have been an emolument. A payment for the loss of that benefit must take its character from that which it replaced, and could not therefore be "from" employment (page 28).

84. The court prefaced its consideration of whether the payment was, alternatively, a benefit arising "by reason of employment" by looking at the formulations we have set out above from the judgments of Lord Denning and Oliver LJ in *Wicks v Firth*. It then referred to the analysis of those approaches by Hutton LCJ in *Mairs v Haughey*. In another passage relied on by Ms Shaw, the court concluded as follows (at pages 29-30):

> I respectfully agree that the test provided by Oliver LJ is more helpful. The argument which Lord Denning was addressing in *Wicks v Firth* went back to the concept of an emolument as being limited to something in the way of a reward for services. The taxpayer argued that the s 61 charge should be limited in the same way. It was in that context that Lord Denning was concerned to emphasise the width of the new benefit provisions. However, as can be seen from later cases, it is clearly established that the concept of reward is not an essential ingredient, even in the case of an ordinary charge under Sch E. If one compares Oliver LJ's formulation of the issue in *Wicks v Firth* with his later references to the Sch E test, in *Bray v Best* for example, it is difficult to see a great difference. Similarly, in *Hamblett v Godfrey* [1987] STC 60 at 71, [1987] 1 WLR 357 at 370 Neill LJ refers to the statement of Viscount Simonds in *Hochstrasser v Mayes* ([1960] AC 376 at 390, 38 TC 673 at 706)—'... the test of taxability is whether from the standpoint of the person who receives it the profit accrues to him *by virtue of his office* [emphasis added]'. Neill LJ goes on to say: 'The question is, was the payment an emolument from the employment? In other words, was the employment the source of the emolument?'
>
> Again, the difference between these formulations and the expression 'by reason of' is hard to detect. It may be that we have moved beyond *Wicks v Firth*, to a point where there is very little difference, if any, between the two tests. In any event, on the facts of this case I cannot see any basis for reaching a different decision under s 61 from that

> under s 181. The commissioners clearly had in mind both. They found that the payment was not linked to the employment during the year of assessment and therefore that it was not 'by reason of' that employment. They recognised the link with the loss of the benefit of the share option scheme. It seems to me that if that is a distinct factor for the purposes of the ordinary Sch E test, as held by the House of Lords in *Abbott v Philbin*, the same will apply under s 61.

85. In *Kuehne & Nagel* the issue was whether a payment found as a fact to be made for two reasons which were not dissociable was an emolument "from" employment. In the Upper Tribunal ([2011] STC 576) it was recorded as "clear from the authorities (and also common ground between the parties) that, in determining whether a payment was 'from' an employment, the fact that an employee would not have received a payment but for his employment is not necessarily decisive": [34]. The Court of Appeal, upholding the FTT and Upper Tribunal, determined that it was possible for a payment to be "from" more than one source, and that if the fact-finding tribunal determined that there were two non-dissociable sources, one of which was employment, it was entitled to find that the payment was an emolument. Mummery LJ stated as follows (at [32] and [33]):

> [32] When considering the cause of, or the reason for, an event or an act in a particular case, the courts steer clear of involvement in general theories of causation. Instead they apply a mix of general principle, legal policy and good-sense pragmatism to determine whether legal liability in accordance with the conditions set by the relevant rules has been established on the particular facts of the case…
>
> [33] All I need say at this point is that the use of 'from' in the idea expressed in the statutory expression 'earnings from an employment' and 'earnings derived from an employment' in a fiscal context indicates, as matter of plain English usage, that there must, in actual fact, be a relevant connection or a link between the payments to the employees and their employment.

86. Mummery LJ also referred at [34] to the fact that appeals are confined to questions of law:

> [34]… it was for the judge in the FTT, entrusted by statute with the judicial function of finding the facts, to consider all the relevant documents and oral evidence and to make findings of primary fact and proper inferences of fact, to which he then had to apply the tax legislation, as interpreted by the courts. It follows that it is not the task of the UT, or of this court, to re-decide or second guess the primary facts, their proper function being limited to questions of law, such as whether the FTT misinterpreted the law, or misapplied it to the facts, or made perverse findings of fact unsupported by any evidence, or reached a conclusion that was plainly wrong.

87. Patten LJ referred (at [50]) to the need for "a sufficient causal link to be established between the payment and the employment". Having reviewed the chief authorities, he then stated as follows (at [52] and [53]):

> [52] It must follow from this that, in order to satisfy the s 9 test, one must be able to say that the payment is from employment rather than from a non-employment source. This has certainly been the approach of the courts in most of the decided cases, examples of which are:
>
> (i) Viscount Simonds in *Hochstrasser v Mayes* at (1959) 38 TC 673 at 706, [1960] AC 376 at 389: 'often difficult to draw the line and say on which side of it a particular case falls';
>
> (ii) Lord Wilberforce in *Brumby v Milner* at [1976] STC 534 at 536, [1976] 1 WLR 1096 at 1099: 'not an easy question to answer';
>
> (iii) Lord Diplock in *Tyrer v Smart (Inspector of Taxes)* [1979] STC 34 at 36, [1979] 1 WLR 113 at 115: 'determination of what constitutes his dominant purpose'; and
>
> (iv) Carnwath J in *Wilcock (Inspector of Taxes) v Eve* [1995] STC 18 at 25, 67 TC 223 at 232: where there is more than one operative cause 'there is an element of value judgment in deciding on which side of the statutory line the payment falls'.
>
> [53] This process of evaluation requires the fact-finding judge to make findings of primary fact based on the evidence as to the reasons and background to the payment and then to apply a judgment as to whether the payment was from the employment rather than from something else…

88. Patten LJ concluded, at [59]:

> If the employment is a substantial and equal cause of the payment, it becomes open to the judge to say that the statutory test is satisfied. The payment is then from the employment even if it is also substantially attributable to a non-employment cause.

89. In the recent decision of *Vermilion Holdings Ltd v HMRC* [2020] UKUT 0162 (TCC), the background and issue were summarised by the Upper Tribunal as follows:

> [1] An adviser to a company took an option over shares in the company instead of fees. The company came to be in financial difficulty. A rescue package was agreed with investors. The package was conditional on the adviser becoming director and executive chairman of the company and cancellation or amendment of the option. The adviser became director and executive Chairman and the option was cancelled and a new share option granted.
>
> [2] The issue in this case is whether the new share option falls within the provisions of s 471 of the *Income Tax (Earnings and Pensions) Act 2003* ('ITEPA') to be treated as an employment-related securities (ERS) option for tax purposes.

90. The Tribunal considered the "by reason of employment" issue at [65] to [82] of the decision. It stated that guidance on that phrase could be found in *Wicks v Firth*, and then set out the respective formulations of Lord Denning and Oliver LJ in that case. It stated, at [71]:

> What we take from *Wicks v Firth* is that the phrase 'by reason of employment' is to be given its ordinary meaning and must be considered in the circumstances of the particular case. We note also that the employment need not be the sole reason: it is enough that the employment was a condition of a benefit being granted.

91. In deciding that the FTT had erred in law in relation to this issue, the Upper Tribunal made this statement, at [78]:

> … in our opinion the FTT has erred in law. It has failed to properly apply the guidance given in *Wicks v Firth*. In particular it has not applied the guidance in respect of how to approach matters where there is more than one cause. It has not properly applied the guidance of Denning MR that the fact of employment need not be the sole cause or even dominant cause, and that it is sufficient that the employment was a condition of the benefit being granted.

92. The tribunal concluded that the option was granted by reason of employment, stating as follows:

> [80] In these circumstances, it seems to us that there was more than one reason why the 2007 Option was granted to Mr Noble. One reason was that there was an existing 2006 Option which could no longer continue in its current form. Another reason was that the 2007 Option was part of a package of measures which included the employment of Mr Noble.
>
> [81] The employment of Mr Noble and the grant of the 2007 Option are two of the conditions of the rescue package. The grant of the 2007 Option was conditional on the other conditions (including the employment of Mr Noble) being satisfied before it could go ahead. It was thus a condition of the granting of the 2007 Option that Mr Noble was employed by Vermilion. Accordingly the test set out by Denning MR was met: employment as director was an operative cause in the sense that it was a condition of the option being granted.

The case law: guidance in this appeal

93. The issue in Mr Charman's appeal is whether the FTT erred in deciding that his Axis Capital shares were, within the terms of section 423 ITEPA, acquired by him in pursuance of a right conferred on him or opportunity offered to him by reason of his employment. What can be drawn from the cases which we have reviewed in considering that issue?

94. The first question is whether there is any material difference between the long-standing emoluments test of whether a payment or receipt is "from" employment and the question of whether an acquisition is "by reason of employment". That is relevant in this appeal because the authorities on which Ms

Shaw relied most heavily included *Abbott v Philbin*, which concerned the emoluments test, and the parts of *Wilcock v Eve* which also dealt with that test.[14]

95. Ms Shaw argued that the two tests were materially indistinguishable, citing as support the observations of Carnwath J to that effect in *Wilcock v Eve*, set out at paragraph [84] above. We do not agree that those observations bear that weight. They are expressed tentatively ("It may be…") and in our view it is clear that "by reason of employment" is intended to be and is wider than "from" employment. That was the unequivocal view of all three judges in *Wicks v Firth*, not only Lord Denning, and Hutton LCJ expressly agreed with those views in *Mairs v Haughey* (at the passage set out at paragraph [78] above). Doubtless there will be factual situations where, as Carnwath J suggested, the two tests would produce the same result. However, it does not necessarily follow in every case that because something is not received "from" employment it is not acquired "by reason of employment". A degree of caution is therefore required in applying authorities on the former to the latter.

96. As to the meaning of "by reason of employment", the formulation proposed by Oliver LJ in *Wicks v Firth* is to be preferred to that of Lord Denning in that case. That follows from *Wilcock v Eve* and *Mairs v Haughey* (CA).

97. We have not found the decision of the Upper Tribunal in *Vermilion* to be of material assistance, since it does not refer to *Abbott*, *Wilcock v Eve* or *Mairs v Haughey*, which fall to be considered in this appeal. However, we note that the conclusion in *Vermilion* is not expressed in terms of a simple "but for" test, and that Oliver LJ's formulation was considered in addition to Lord Denning's.

98. Bearing in mind the need to avoid extensive judicial gloss to the terms of a statute, we respectfully consider that Oliver LJ's formulation of the "by reason of employment" test is an appropriate starting point. So, in this appeal the question can be expressed as this: what enabled Mr Charman to acquire his shares in Axis Capital, or, put another way, what was the source of that acquisition?

99. In relation to the emoluments test, Carnwath J observed in *Wilcock v Eve* that the most difficult cases have concerned borderline situations where there was more than one operative cause for a payment. In such situations, he said, an element of value judgment is involved in deciding on which side of the line the payment falls. That observation was cited with approval by the Court of Appeal in *Kuehne & Nagel*, which held that it is open to a tribunal which finds a substantial causal link between a payment and employment to decide that it is "from" employment, even if there were other reasons for the payment. We can see no logical reason to take a different approach to the question of whether an acquisition is made pursuant to an offer or opportunity made available by reason of employment. It would be surprising if the "by reason of employment" test was narrower in this respect than the emoluments test. In other words, it would be

[14] As we discuss below, Ms Shaw also relied on the parts of *Wilcock v Eve* which concern the separate issue of "by reason of employment".

possible for an acquisition to be enabled by, or to have as its source, both employment and some other reason. The tribunal must nevertheless determine what enabled or was the source of an acquisition or receipt.

100. We consider below whether, as Ms Shaw submitted, on the authority of *Abbott v Philbin*, the FTT erred in this case in concluding that Mr Charman's Axis Capital Restricted Shares had as their source his employment.

The FTT's reasoning

101. We have set out the FTT's decision on this issue in full at paragraph [58] above. We must consider the basis on which the FTT reached that decision in order to determine whether it misdirected itself in law or reached a decision which was not reasonably open to it, or was perverse, on the facts.

102. The FTT began by rejecting Mr Charman's argument that the share-for-share exchange changed the source of the income arising when the restrictions on his shares were lifted. It stated that *Abbott* and *Wilcock v Eve* could be distinguished on three grounds. First, those cases dealt with the exercise of share options, which is accepted for common law purposes as having a source other than employment. Second, while those cases suggested the need for "a relatively tight nexus" between receipt and employment, that was in part because the issue in those cases was whether the gain on exercise of the option derived from the employment; the position was different in relation to the Axis Capital shares, "which merely represent a change in the form of an existing asset (the Axis Specialty shares) into another asset (the Axis Capital shares) of the same economic value". Third, the FTT accepted that this was a borderline case in which there was more than one "operative cause" of the taxable income, but considered that the "ultimate cause (or source)" was Mr Charman's employment with Axis Specialty.

103. The FTT considered that treating the share-for-share exchange as breaking the nexus and changing the source would be an "overly mechanistic" approach to the law. It would also result in a rather surprising conclusion which would provide "a very ready loophole for anyone wishing to avoid tax on their employee shares". It referred to the formulation referred to in *Wilcock v Eve* as to whether employment was the source of the emolument and concluded that "the only realistic response to this question in respect of Axis Capital shares is yes".

104. In relation to the mechanics of the reorganisation, the FTT considered that the cancellation of Mr Charman's Axis Specialty shares did not have the result that he had divested himself of his rights as an employee to shares. His rights had been altered "only in a very formalistic sense", and the essential purpose of the exchange was to ensure that existing shareholder rights were changed in form but not in substance.

105. We consider that three main reasons can be identified for the FTT's decision, leaving aside for the moment the "loophole" concern. First, *Abbott* and

Wilcock v Eve can be distinguished. Second, while there was more than one operative cause, the ultimate cause or "source" of the Axis Capital shares was Mr Charman's employment. Third, it is necessary to approach the question realistically, and to avoid an overly mechanistic approach. The effect of the exchange on Mr Charman's rights over shares was more formalistic than substantive and did not operate to break the employment nexus.

106. Mr Charman argues that the FTT misdirected itself in law in two respects, namely in adopting what Ms Shaw says is Lord Denning's discredited "but for" test, and in wrongly distinguishing *Abbott* and *Wilcock v Eve.*

Discussion

107. We do not accept that the FTT adopted Lord Denning's formulation of "by reason of employment" in *Wicks v Firth*. It explicitly approached the question, we consider correctly, by determining what it considered to be the "cause" or "source" of the Axis Capital shares. It correctly directed itself as to that approach, and there is no indication, in either its reasoning or conclusion, that it decided the question on the basis that Mr Charman could not have acquired his Axis Capital shares "but for" being or remaining an employee at the time he acquired them. To the contrary, in identifying that this was a case where there was more than one operative cause and the task was to find the ultimate cause or source, the FTT was implicitly rejecting a simple "but for" test.

108. Turning to the authorities which Mr Charman says the FTT wrongly distinguished, Ms Shaw submitted that the decisions in *Abbott* and *Wilcock v Eve* were "materially indistinguishable" from the relevant issue in this appeal. Since the primary significance of *Wilcock v Eve* is its reliance on *Abbott*, we begin by considering that submission in relation to *Abbott.*

109. At [129] of the Decision, the FTT records Ms Shaw's reliance on *Abbott* by reference to an extract from the judgment of Lord Radcliffe, in which he stated that "the advantage which arose by the exercise of the option…was not a perquisite or profit from the office during the year of assessment; it was an advantage which accrued to the appellant as the holder of a legal right which he obtained in an earlier year…". Viscount Simonds said that, while the grant of the option was an emolument, the subsequent profit on its exercise was not, because that profit was due to numerous factors which had nothing to do with the employment, but rather to the "adventitious prosperity of the company in later years", and what Lord Radcliffe called the "judicious exercise" of the option rights. While the decision concerned a share option, Ms Shaw submitted that the reasoning was equally applicable to an employee shareholding such as Mr Charman's restricted shares. The profit realised by Mr Charman (when the shares became unconditional) arose from his legal right as shareholder, like the profit on exercise of the option in *Abbott.* Mr Abbott could not have exercised his option "but for" being granted it (as employee) and but for remaining an employee until exercise, but that did not mean that the source of the profit on exercise was

employment. It followed that the source of Mr Charman's Axis Capital shares was not his employment, but his legal right as shareholder in Axis Specialty.

110. We have concluded that *Abbott* does not have the result for which Ms Shaw contends. We reach that conclusion for several reasons. As we have explained, we do not consider that it necessarily follows that because something is not an emolument, it cannot be received "by reason of employment". In any event, on a careful reading we interpret the relevant passages in *Abbott* as dealing not with the source of an asset (in this appeal, the Axis Capital shares), but with the source of a profit. The quotation from Viscount Simonds set out at paragraph [69] above is concerned with the source of "the increased difference between the option price and the market price" on exercise, not with the source of the option or (if it is separable) the right to exercise. Similarly, Lord Radcliffe addresses the source of "the quantum of the benefit, which is the alleged taxable receipt", being the profit on exercise. The decision emphasises that the profit on exercise does not result from employment, or continuing employment, in the way that the grant does. This is illustrated by Lord Radcliffe's example of the option being exercised nine years after grant, when the market value of the shares might have changed out of all recognition, clearly demonstrating that the profit did not arise from employment, whereas the source in the year of grant was plain.

111. The question in this appeal is not the source of the profit realised by Mr Charman when the restrictions on his Axis Capital shares were lifted. It is whether his interest in those Axis Capital shares was acquired in pursuance of a right or opportunity arising by reason of employment. We do not consider that *Abbott* determines that question in the negative. It does not follow from *Abbott* that the share-for-share exchange necessarily broke the nexus between the two shareholdings.

112. In relation to *Wilcock v Eve*, as explained above we broadly agree with the approach set out in that case to the "by reason of employment" test. In relation to the effect of *Abbott* on the issue in this appeal, we do not consider that *Wilcock* alters the position. It cannot, of course, affect what was and was not decided by the House of Lords in *Abbott*, and it is in our view not surprising that a payment made in cancellation of a right the profit on which would not (on the authority of *Abbott*) have been an emolument should have been held on the facts not to have been an emolument or a benefit received by reason of employment.

113. It follows from our analysis that the first basis on which the FTT distinguished *Abbott* (and *Wilcock*) was unduly simplistic. The fact that those cases concerned options rather than shares is not *of itself* a justifiable basis of distinction. However, for the reasons we have given *Abbott* is not authority for the broad proposition put forward by Ms Shaw as to the source of the Axis Capital shares.

114. The second and third reasons given by the FTT for not following those two cases are in substance an explanation of its approach to the statutory test of

"by reason of employment". We therefore turn to consider the approach which the FTT took to that question.

115. The practical dilemma to which Oliver LJ's test of "enablement" gives rise in the appeal is this. If one asks "what enabled Mr Charman to acquire his Axis Capital shares?", Ms Shaw would doubtless reply (with some justification) "the fact that he was a shareholder", and Mr Nawbatt would doubtless reply (with some justification) "the fact that he had acquired shares in Axis Specialty as an employee, and retained them because he was still an employee at the time of exchange".

116. At first blush, this would suggest that this is a case where there was, as the FTT considered, more than one operative cause for the acquisition of the Axis Capital shares, making it necessary for the tribunal to determine whether what it described as "the ultimate cause (or source)" was Mr Charman's employment. However, the issue in our view can be more helpfully framed in the following terms. Given that Mr Charman was eligible to participate in the exchange because of his shareholding in Axis Specialty, is it relevant in considering the "by reason of employment" question to take into account the surrounding facts, circumstances and characteristics of the shareholdings and the exchange? Or does one ignore these factors and look no further than the fact that Mr Charman was an Axis Specialty shareholder, and therefore, as Ms Shaw says, must be regarded in the same way as regards his acquisition of Axis Capital shares as any other shareholder?

117. Approaching the question in this way, in our opinion the answer is clear. Starting from the proposition that, as we have concluded, a binary "but for" test is insufficient, it must be the case that the question of whether the interest in the Axis Capital shares was acquired in pursuance of a right or opportunity arising by reason of employment falls to be considered by reference to all relevant facts and circumstances. In particular, the FTT was entitled to take into account (a) that the shareholding which enabled Mr Charman to participate in the exchange was acquired by reason of employment, (b) the terms on which Mr Charman held his Axis Specialty Restricted Shares under the Restricted Stock Agreement and Plan, including the risk of forfeiture if he ceased to be an employee and his lack of rights as a shareholder until restrictions were lifted (see paragraph [52] above), (c) the preservation of the employee-related restrictions and conditions applicable to the Axis Specialty shares in relation to the Axis Capital shares, and (d) whether the reorganisation was presented to shareholders as intended to effect a substantive change in their rights.

118. It should be emphasised that none of these factors compelled a conclusion that the Axis Capital shares must have been acquired by reason of employment. Additionally, some factors carried more weight than others in carrying out the necessary evaluative exercise. However, it was right that that exercise should take relevant factors and circumstances into account in assessing what in substance enabled or was the source of the acquisition of the Axis Capital shares. Taking those factors into account, it would not be inappropriate to describe the nature of

the rights held by Mr Charman at the time of the share exchange as "intimately connected with the employment", rather than enjoyed in another capacity (see Carnwath J's comment to that effect in *Wilcock v Eve*, set out at [83] above, in the context of the emoluments test).

119. The FTT was entitled to take the realistic approach that it did in deciding what the "source" was. It did not misdirect itself in law. Nor did it reach a conclusion which failed to take into account relevant factors or was perverse.

120. We did not find that the issue of the subsequent changes to the legislation to deal with reorganisations[15] (see [61] above) shed any additional light on the question of statutory construction. It formed no part of the FTT's decision, and we express no view on the issue.

121. The FTT accepted HMRC's argument that if the exchange operated to convert shares which were clearly employment-related securities into shares which were not, that provided a surprising loophole. That is wrong to the extent that the legislation imposes a charge to income tax on a disposal such as the exchange in this case. HMRC did not pursue such a charge in Mr Charman's case. However, that may have reflected the short passage of time (around two months) between the acquisition of the Axis Specialty shares and their exchange.

122. As explained above, a clear purpose of the ITEPA legislation is to "wait and see", so that the tax charge focuses on the likely increase in value by the time the restrictions are lifted (in this case, 3 years after the acquisition). It does appear that Mr Charman's construction would frustrate that purpose to a degree, since it would effectively wash out the charge at the point of the share-for-share exchange and prevent a charge arising when the restrictions are lifted. However, for our part we would place no great weight on this point, although we would note that HMRC's approach would not result in a double charge, because the value of the shares exchanged would be deductible in calculating the chargeable amount under section 428 ITEPA (see [50] above). The critical question is the meaning of the statutory words, construed purposively, and their application to the facts, viewed realistically (*UBS AG v HMRC* at [66]).

123. We conclude that the FTT did not err in law in its conclusion on this question. We do not consider that the errors made in the first basis on which it distinguished *Abbott v Philbin* and *Wilcock v Eve*, or its discussion of the perceived loophole, affect the key conclusion it reached that, on the facts, the "source" of the Axis Capital Restricted Shares was Mr Charman's employment.

Disposition

124. HMRC's appeal is allowed, with the result that all of Mr Charman's share options were acquired at the date of grant.

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[15] Section 421D ITEPA.

125. Mr Charman's appeal is dismissed.

MRS JUSTICE FALK

JUDGE THOMAS SCOTT

RELEASE DATE: 27 August 2020