TC02656

Appeal number: TC/2012/06914

INCOME TAX – whether 'termination payment' included repayment of purchase of an option in company EMI scheme – yes - Investors Compensation Scheme v West Bromwich Building Society considered – whether the payment included sum referable to employee's employment contract – no – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

IAN JOHNSON **Appellant**

- and -

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

TRIBUNAL: JUDGE MISS JILL GORT
MR DAVID WILLIAMS

Sitting in Reading on 26 March 2013

The Appellant appeared in person

Mr S Bates, presenting officer of HMRC, appeared on behalf of the Respondents

DECISION

1. The appeal is against a closure notice issued by Her Majesty's Revenue & Customs ("HMRC") on 14 February 2012 which was varied following a statutory review on 11 June 2012. By the original decision a closure notice was issued under s.28A(1) and (2) Taxes Management Act 1970 in respect of tax year 2007/8 and Mr Johnson's self-assessment tax return was amended to include as income chargeable to income tax the sum of £12,000; additionally a penalty of £1,200 was imposed. Following the review the sum of £12,000 was reduced to £11,628 and the penalty was removed.

2. The issue raised by the appeal is whether or not a payment of £75,700 ("the Payment") made to Mr Johnson under the terms of a Compromise Agreement ("the Agreement") on the cessation of his employment at R R Richardson Limited ("the Company") included the repayment of the sum of £30,000 paid by Mr Johnson to the Company for a Share Option Agreement ("the Option Agreement").

The Facts

3. Mr Johnson worked for the company as Sales Director of Richardson Social Housing Limited, which was part of R R Richardson Group Ltd, between August 2005 and 6 December 2007. Prior to taking up that appointment from about 1996 he had worked at a company called Morrison Construction ("Morrisons") which was jointly owned by two brothers, Gordon and Frazier Morrison. Morrisons was subsequently sold at a good profit but Mr Johnson and Gordon Morrison remained there until in or about 2005 when Gordon Morrison acquired all the assets of the Company. Gordon Morrison's intention was to run the Company for about five years and then sell it on at a profit, as he had sold Morrisons. He invited Mr Johnson and a fellow former employee of Morrisons, Graham Reid, to join the Company. As an incentive, both Mr Reid (who became Managing Director of the Company) and Mr Johnson were invited to enter the Option Agreement under an Enterprise Management Incentive scheme ("EMI"). This was a qualifying EMI scheme under Chapter 9 and Schedule 5 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"). Other employees of the Company were offered share options for the sum of £10,000. In order to purchase the option, Mr Johnson took out a further mortgage on his house in the sum of £30,000.

4. The EMI scheme which is dated 30 November 2005 was in the form of an Agreement between:

(1) R R Richardson Group Limited ("the Company");

(2) R R Richardson (Trustees) Limited ("the Grantor"); and

(3) Ian Johnson.

5. Clause 2.1 provides *inter alia* that:

"The Grantor hereby grants to the Option Holder an option ("the Option") to acquire a maximum of £30,000 ordinary shares in the capital of the Company at the Exercise Price."

The Exercise Price is given as nil per share, an option was granted to Mr Johnson following his payment of £30,000.

6. Schedule 2 of the EMI scheme incorporates the Rules of the Company which had been adopted on 17 October 2007. By Clause 7.3 the Rules provide:

"Upon the Option Holder ceasing to be an employee of the Company or subsidiary the Grantor may, in its absolute discretion, either:

"7.3.1 make a cash payment to the Option Holder in consideration for the lapsing (release) of his Option. The amount of any payment made pursuant to this Rule 7.3.1 shall be determined in the absolute discretion of the Grantor; and/or

7.3.2 permit the Option Holder to retain all or part of his option in which case the Grantor shall resolve to do so within 30 days from (and including) the date on which the Option Holder ceased to be an employee of the Company or subsidiary.

7.4 If a Disqualifying Event occurs which would result in an Option ceasing to be a Qualifying Option, the Grantor may at its discretion allow the Option Holder to exercise his option during the period ending 40 days after the occurrence of the Disqualifying Event. To the extent not so exercised, the option shall remain exercisable (subject to the rules of the Scheme) but shall no longer be a Qualifying Option."

7. Mr Johnson's terms and conditions of employment are contained in a letter from the Company dated 22 July 2005. They contain a clause which provides for 6 months notice of termination of employment by either side. There is a further clause stating that "by mutual agreement between both parties (sic)" the right to notice may be waived. There is no clause providing for any payment in lieu of notice.

8. In or about 2007 Gordon Morrison brought a new Chief Executive Officer into the Company. Despite trying for several months, neither Mr Johnson nor Mr Reid could work with this man and informed Gordon Morrison of this fact. Eventually at a Board Meeting on 6 December 2007 it was agreed that both Mr Johnson and Mr Reid would leave the Company, effective immediately. It was Mr Johnson's evidence that at that meeting Gordon Morrison agreed to repay both him and Mr Reid the £30,000 they had paid into the EMI scheme.

9. On 8 January 2008, following legal advice from a Mr Alex Monaco of CJ Jones, who was acting as the relevant independent advisor, an agreement was reached whereby Mr Johnson was to be paid £75,700. In a letter dated 19 December 2007 Mr Monaco had written to Mr Johnson stating *inter alia*:

"You have accepted the severance payment in full and final settlement of any claims that you may have against R R Richardson Limited … You were happy with the settlement and I advised you as to the content of the Agreement. You said that you had invested £30,000 into the Company which you would stand to lose if you left without signing the Compromise Agreement.

Your money under the Compromise Agreement includes payment in lieu of six months wages under your contract of employment. You have given the employer a tax indemnity although the first £30,000 should be tax free, the balance plus your benefits including pension, health, life and medical insurances are taxable."

10. The Compromise Agreement where relevant provides:

"2.2 The parties acknowledge that the circumstances surrounding the termination of employment could give rise to contractual and/or statutory claims including unfair dismissal. The parties have entered into this Agreement to record and implement the terms of the termination of the Employee's employment and the settlement of all actual or potential claims.

…

4.1 The employer shall pay to the employee without admission of liability the sum of £75,700 … ("the Termination Payment") by way of compensation less any income tax or other sum the employer is required by law (or entitled under the terms of this Agreement) to deduct. For the avoidance of doubt the termination payment includes the employee's entitlement if any to a Statutory Redundancy Payment in the sum of £930.

…

4.4. The employer agrees not to make any deduction from the first £30,000 of the Termination Payment on the basis that the parties believe that under normal HM Revenue & Customs Rules, the first £30,000 … of the Termination Payment may be paid to the Employee tax-free.

…

11.1 The terms of this Agreement have been agreed between the parties without any admission of liability in full and final settlement of particular statutory rights the employee has in connection with the termination of the employee's employment, including unfair dismissal.

…

14.3 This Agreement constitutes the entire agreement between the parties in respect of its subject matter and supersedes all previous agreements and understandings between the parties …"

11. On 25 January 2009 Mr Johnson submitted his tax return for 2007/8 and entered £45,700 as taxable earnings, omitting the first £30,000 which he understood to be tax exempt as a redundancy payment. Mr Johnson subsequently realised that, as he believed the sum had included the £30,000 EMI repayment, he should also have omitted that sum, having made no taxable gain on that amount. He telephoned HMRC's advice line and was told that tax relief should have been due at the time the £30,000 payment was made and he should write to HMRC. This Mr Johnson did on 3 February 2009, and subsequently he submitted an amendment to the tax return and received a refund of £12,010.03 in April 2009.

12. Upon receiving a letter from HMRC's Compliance Officer on 3 February 2010, Mr Johnson submitted payslips, the EMI scheme documents, the Compromise Agreement, mortgage and solicitor's letters and a breakdown of the termination payment. This last he gave as follows: £45,700 by way of compensation for loss of employment (i.e. six months salary in lieu of notice) and £30,000 EMI scheme reimbursement. HMRC contacted the Company and by a letter dated 16 March 2010 was informed that the detailed breakdown of Mr I.L. Johnson's P14 end of tax year 2008 consisted of 9 months' basic pay of £60,000 and a car allowance of £5,341.67. In addition it was stated that: "Mr Johnson also received a termination payment of £75,700 inclusive of the exempt amount of £30,000 and statutory redundancy payment of £930". On 16 December 2010 HMRC contacted the Company and was informed by the Company Secretary that the payment "was definitely not a refund of his investment" and also that "if the payment of £75,700 had included any of the investment then it would have been repaid by the EBT not by the Company". Subsequently by a letter dated 15 March 2011 the Company wrote to HMRC:

> "Our view was and continues to be that the amount of compensation agreed between the parties is a global sum which satisfies both parties' positions. It is not broken down into constituent elements because for either party to do so would be to attribute or accept liability for a particular act."

13. Mr Johnson accepted that it was the case that both parties were satisfied, but at the hearing he referred the Tribunal to the reference in Mr Monaco's letter of 19 December 2007 (see above) to his standing to lose the £30,000 he had invested in the Company if he did not sign the Compromise Agreement. It was his evidence to the Tribunal that he would not have signed the Agreement if it had not included the repayment of his £30,000 investment.

14. By a letter dated 25 May 2011 HMRC wrote to Mr Johnson stating *inter alia* that it was believed that of the £75,700, £45,000 represented six months wages, statutory redundancy was £930 and 16 days holiday pay was "say" £5,000. The paragraph concluded:

> "… and presumably the balance of £24,770 is compensation for loss of office/ other items. There is therefore no part of the payment left which could be a refund of your £30,000.

The lump sum being considered to be £45,700, HMRC consequently concluded that there was £12,000 further tax due.

15. In reply to HMRC's letter of 25 May, Mr Johnson sent them a copy of his December 2007 payslip which showed that he had been paid £5,070.77 holiday pay, prior to receipt of the £75,700. His November 2007 payslip was also sent which showed that his salary for the month was £6,866.67 and his car allowance was £595. The total of these sums is £7,461.67 x 6 = £44,770. Mr Johnson believes that the £75,700 was arrived at by calculating six months pay, adding £930 for statutory redundancy and £30,000 being the return of his £30,000.

16. HMRC subsequently on 9 February 2012 issued the decision letter date £12,000 tax was due and a penalty of 10% was imposed. Further to Mr Johnson's appeal, this decision was reviewed and the basis of the decision and the amount were altered and the penalty was withdrawn. The review letter refers to Clause 4.4, 7 and 7.3 of the EMI scheme, (see above) as well as to the solicitor's letter of 19 December 2007, the Company's refusal to give a full breakdown of the figure, Mr Johnson's own breakdown of the sum and the advice given to him by HMRC to amend his return.

17. After referring to ITEPA the review officer stated:

> "You received £44,770 as payment in lieu of six months notice as laid down in your contact of employment. The character of this payment is not compensation for loss of employment by reason of redundancy as laid down in s.401(1) stated above but is instead the payment made because you did not receive proper notice as set down in your original contract of employment. Such contractual payments are fully assessable as earnings under s.62 ITEPA 2003 and no exemption under s.403 applies.
>
> As such the sum of £44,770 is the minimum amount assessable on your from the £75,700 total payment.
>
> …
>
> With regard to the remaining £30,000 there is still an unresolved dispute as to whether it relates to the return of your EMI investment, as you have indicated, or un-contracted compensation on redundancy. If the sum is the return of your investment then no further income tax arises and if it is compensation on redundancy it will attract the remaining £29,070 (£30,000 less £930) of the s.403 exemption leaving only a further £930 assessable to income tax. As the tax on the disputed further £930, even if proven, is small in context with the inquiry I do not propose to pursue this matter.
>
> If, as you say, the payment includes your £30,000 EMI scheme investment being returned then no relief is due on the initial payment.
>
> Further tax is therefore due on £44,770 of the payment which amounts to £11,628."

HMRC's case

18. Other than the reasoning in the review decision which is in part set out above, HMRC relies on the Tribunal decision in the case of *Graham Reid*, who was Mr Johnson's former colleague, which was heard by the First-tier Tribunal on 17 February 2012. In that case the wording of the Compromise Agreement at paragraph 14.3 were considered to rule out any consideration of Mr Reid's terms of employment under a revised contract. The Tribunal was unable to find either an implied term in the Compromise Agreement or infer that the sum of £30,000 should be included as part of Mr Reid's termination payment which, by Clause 4 of the Compromise Agreement was "by way of compensation".

19. Mr Bates referred us to the principle of contractual construction set out by Lord Hoffman in the case of *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896 and submitted that HMRC must only have regard to the terms of the Agreement and not to any prior negotiations between the parties.

20. It was submitted by Mr Bates that the unidentified element of £30,000 was a non-contractual payment, which was possibly compensation for unfair dismissal, a non-statutory redundancy payment or compensation for surrendered employment rights. It was accepted that £30,000 was exempt from tax by virtue of ss.401-404A ITEPA 2003. Although s.403 ITEPA 2003 imposes a £30,000 threshold on 'tax free' termination payments which because of the redundancy payment of £930 leaves only £29,070 to be set against the non-contractual payment, HMRC had by concession allowed relief in full on the non-contractual element of the Termination Payment.

Mr Johnson's case

21. Mr Johnson's primary case is that of the £75,700 payment, £30,000 represented repayment of the £30,000 option payment, £44,770 was a non-contractual payment and £930 was a statutory redundancy payment.

22. In support of his case that £30,000 was a repayment of his investment, he points to the fact that, as recorded by the solicitor, he was only prepared to sign the Agreement if he recovered the £30,000, and to the Company's letter in which it was said that the sum of £75,700 "satisfied both parties' positions".

23. He also submitted that his contract of employment was not terminated by six months notice and that there was no mutual agreement to waive notice. There was therefore no contractual payment and the payment he received was by way of termination of employment without proper notice and therefore fell within s.401 ITEPA 2003 and did not come under s.62 of ITEPA as taxable earnings.

24. We were referred to HMRC's manual EIM 12805 'Termination payments and benefits', where HMRC, when determining the reasons for an employment ending and where there is a payment, are instructed that "the first task is to identify each element within the package" and that this may involve interviewing those involved as

well as seeing all the documents and notes of meetings. We were also referred to EIM 12810 which deals with termination payments and starts by stating:

> "Having found what each element of a termination package is for, each element should then be looked at separately …"

25. Mr Johnson complained that HMRC did not make any effort to comply with these requirements.

26. Mr Johnson pointed to the language of the statement of case where at paragraph 19 it is stated:

> "HMRC says that termination payment of £75,700 probably comprised the following elements …" and then referred to the £30,000 as an "unidentified" element, which in paragraph 22 of the statement of case is described as "a non-contractual payment possibly compensation for unfair dismissal or a non-statutory redundancy payment …".
>
> (underlinings added)

27. Given the uncertainty in HMRC's findings, Mr Johnson submitted that the appeal should be allowed.

Reasons for decision

28. In the case of *Investors Compensation Scheme*, referred to above and which was relied on in the case of *Graham Reid*, Lord Hoffman made what he called "general remarks about the principles by which contractual documents are nowadays construed" as follows:

> "(1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.
>
> (2) The background was famously referred to by Lord Wilberforce as the "matrix of fact", but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have effect the way in which the language of the document would have been understood by a reasonable man.
>
> (3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.

(4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax. (see *Mannai Investments Co. Ltd v. Eagle Star Life Assurance Co. Ltd* [1997] 2 WLR 945.

(5) The "rule" that words should be given their "natural and ordinary meaning" reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude that the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *the Antaios Compania Neviera SA v. Salen Rederiera A.B.* 1 AC 191, 201)

> "… if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense."

29. In the present case Mr Bates referred only to the passage excluding previous negotiations of the parties. In our view he is wrong to do so. Lord Hoffman (whose remarks are obiter) was referring to a court construing documents in the context of a contract where the parties were at odds as to the proper meaning to be attached to that contract. Here the Tribunal is concerned with HMRC's interpretation of a contract to which it was not a party. It is clear from HMRC's manual (extracts of which are cited above) that it has a duty which is not identical to that of a court construing a contract. In the present case HMRC did make several attempts to ascertain from the company what the individual component sums were under the Agreement, but was unable to do so. That does not mean that it is obliged to look at the Agreement alone without more. Unlike the Tribunal in the case of *Graham Reid*, whichi is not binding on us, we do think it was not only open to HMRC to look outside the specific terms of the Agreement, but in circumstances where the party which had drawn up the Agreement would not divulge its composition, they were, given the terms of their own manual, obliged to do so when determining Mr Johnson's tax liability. Lord Hoffman in his "general remarks" refers to "all the background knowledge reasonably available" and in this case that background knowledge includes the fact of Mr Johnson having paid £30,000 for an option, and his unwillingness to reach an agreement which should not reflect that fact. It does not require any distortion of the terms of the Agreement to conclude that it comprises a sum in respect of the option agreement as well as a sum in respect of the abrupt termination of Mr Johnson's contract of employment.

30. The fact that the Agreement at Clause 14.3 states that it constitutes "the entire agreement between the parties in respect of its subject matter and supersedes all

previous agreements and understanding between the parties" in our judgment adds force to Mr Johnson's case that £30,000 of the total sum negotiated does represent the repayment of the £30,000 he paid for an option, given that it was specifically known that he was not prepared to sign the Agreement unless that sum were included, and the content of the solicitor's letter to this effect could properly be taken into account by HMRC. There is no dispute that Mr Johnson had invested £30,000 in a share option, it is in our view inconceivable that he would sign an agreement which did not recognise that fact, given that the agreement in question precluded him from taking any separate action in respect of the option.

31. HMRC accepted Mr Johnson's assertion that the termination payment included 6 months wages and car allowance, but concluded that this was referable to his contract and should be treated as made in lieu of notice and taxed as earnings within s.62 ITEPA. We do not accept this. Mr Johnson's contract does not provide for any payment in lieu of the six months notice to which he was entitled. We deem the Agreement to be a separate legal document, which by reason of Clause 14.3 is to be construed without reference to the employment contract and therefore any payments contained in it in respect of loss of employment are within s.401 ITEPA and are to be paid free of tax.

32. In the circumstances we allow this appeal and determine that £30,000 of the payment was in respect of Mr Johnson's option, and £930 was referable to statutory redundancy with the remainder being a non-contractual sum in respect of compensation.

33. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

MISS J C GORT
TRIBUNAL JUDGE

RELEASE DATE: 18 April 2013