TC04812

Appeal number:TC/2010/06794
TC/2012/04079

INCOME TAX and NICs –whether monies paid by first appellant to second appellant (and others) for the acquisition of certain rights forming client connections income "from" employment and thus liable to income tax and NICs – no – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

SMITH & WILLIAMSON CORPORATE SERVICES LTD — **First Appellant**

- and -

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

PATRICK SMILEY — **Second Appellant**

- and -

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

TRIBUNAL: JUDGE DAVID DEMACK

Sitting in public in London on 21, 22 and 23 May 2013

Jolyon Maugham of counsel for Smith and Williamson Corporate Services Ltd
James Rivett of counsel for Patrick Smiley

Jane Hodge of HMRC Appeals and Review Local Compliance for HMRC

DECISION

Introduction

1. Smith & Williamson Corporate Services Ltd ("SWCS") and Smith & Williamson Investment Services Ltd ("SWIM") are two companies in the NCL Smith & Williamson group, that being the trading name of NCL Investments Ltd ("the Group"). On 16 November 2006 SWIM entered into a contract ("the 2006 Contract") with Mr Patrick Smiley ("Mr Smiley") and other members of a team of individuals ("the Team") under the terms of which it acquired certain client relationships of the Team. Under that contract, SWIM made certain payments in tax year 2008/09 to Mr Smiley for a share in the relationships. He returned the payments in his self-assessment tax return as chargeable to capital gains tax in the year to 5 April 2007. HMRC did not accept that the payment was so chargeable, and amended the return to show the payments as being "from" his employment, and chargeable to income tax in the year to 5 April 2009. Those amendments were followed by the determinations and notices which are under appeal, and are detailed below.

2. Although the payments were made by SWIM, SWCS is the first appellant because at roughly the same time as it acquired the Team's individual client relationships, Mr Smiley became its employee and thus, if the company's appeal fails, it is common ground that SWCS will be liable for the tax concerned.

3. It was as a consequence of the commonality of issue that the tribunal directed that Mr Smiley's appeals be heard together with that of SWCS. As part of that direction the tribunal specified Mr Smiley's appeal as a lead case in respect of three different appeals raising a common issue under rule 18(2)(a) of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009.

4. In the event that I were to find that part only of the payment to Mr Smiley was from employment, a subordinate issue would arise as to whether SWCS ought to have operated PAYE in respect of the payment.

5. SWCS appeals against:

(i) determinations by HMRC dated 29 July 2010 made under reg 80 of the Income Tax (Pay as You Earn) Regulations 2003 ("the 2003 Regulations") in the sum of £1,157,374. Those determinations relate to liabilities said to arise on the part of SWCS in respect of the members of the Team who are, or were, employees of the Smith & Williamson group of companies ("the Group").

(ii) notices issued by HMRC on 29 July 2010 under s.8 of the Social Security Contributions (Transfer of Functions) Act 1999 charging NICs of £400,217.58. The decisions contained in those notices relate to liabilities that arose on the part of SWCS, again in respect of members of the Team.

6. The effect of the two sets of proceedings is that the SWCS appeal will determine all the reg.80 decisions and the NIC decisions to which they relate.

7. Mr Smiley appeals against:

(i) a closure notice issued on 9 January 2012 under s.28 of the Taxes Management Act 1970 ("TMA") by which HMRC amended his self-assessment tax return to reduce by £92,209.20 the amount of tax payable for the year 2006/07. (Although the appeal against that closure notice remains formally before the tribunal, no issue in fact arises in relation to it. The effect of the notice was to amend Mr Smiley's self-assessment return for the year 2006/07 to eliminate a liability to capital gains tax).

(ii) a second closure notice also issued under s.28 TMA on 9 January 2012 determining that Mr Smiley received additional remuneration of £957,295 in tax year 2008/09. (Although the effect of that notice was to conclude that Mr Smiley received additional remuneration of £957,295 chargeable to income tax, that amendment was subject to credit of £382,918 income tax treated as deducted at source by SWCS (pursuant to reg 185(5) of the 2003 Regulations). In consequence, the closure notice required no additional tax payment by Mr Smiley).

8. As Mr James Rivett, counsel for Mr Smiley, observed, a peculiarity of Mr Smiley's appeal is that in the case of one of the closure notices, the subject of the proceedings, Mr Smiley is arguing that his liability to tax is significantly greater than that sought by HMRC. It is HMRC's case that, in the event that they are wrong and the payment to Mr Smiley is not taxable as employment income in his hands, it is not chargeable to capital gains tax. In that event the sum concerned escapes taxation.

9. As I mentioned above, Mr James Rivett appeared for Mr Smiley. Mr Jolyon Maugham of counsel represented SWCS, and Ms Jane Hodge of the Appeals and Reviews section of HMRC appeared for them. They produced three bundles of copy documents and bundle of legislation and authorities. Oral evidence was given by Gareth Pearce, chairman and chief executive of Smith & Williamson Holdings Ltd ("Holdings"), the Group holding company, the Viscount Cobham, formerly managing director of Smith & Williamson's investment management and banking division, and Mr Smiley himself.

10. On the first day of the hearing a question arose as to whether the tribunal had jurisdiction to hear SWCS's appeal against the NIC decisions made against it. Following argument, I am satisfied that the tribunal does have such jurisdiction; it arises from s.3 of the Tribunals, Courts and Enforcement Act 2007 combined with reg.80 of the 2003 Regulations and ss.31 and 50 of TMA. And, in so far as SWCS claims that its appeal against the reg.80 determination should be allowed on the basis that it was issued to the wrong entity, the provisions of s.684 (11)(7A) of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") in my judgment cure that issue. That subsection provides that "Nothing in PAYE regulations may be read – (a) as preventing the making of arrangements for the collection of tax or other amounts in such manner as may be agreed by, or on behalf of, the payer and an officer of

Revenue and Customs." I am satisfied that an "arrangement" between HMRC and SWCS exists whereby SWCS is treated as the PAYE entity for all Group employees, and arose from the general course of dealing between the Group and HMRC.

The facts

11. Most helpfully, Mr Maugham prepared a paper entitled "Suggested material findings of fact", saying that it was intended to be uncontroversial and not to address contentious points. Having carefully considered the paper and found it to meet those criteria, I have in part used it as the basis of my findings of fact.

12. Since 1996 Mr Smiley has been head of what became "the Team". The other members were Henrietta Clark, Mark Boucher, Sophia Chambre, Shane Chichester, William Fisher, Annabel Somers and Rupert Fleming. In 1996 the Team were employed by Panmure Gordon, and later by Leopold Joseph & Sons Ltd. The last mentioned was later taken over by Bank of Butterfield ("Butterfield"). Between 1996 and 2004 the Team built from scratch a customer portfolio exceeding £400 million.

13. The Group is an independent professional and financial services group which currently employs some 1500 people. It is a leading provider of accounting, financial advisory and investment management services to private clients, professional practices and mid-sized corporations. Most of the Group's employees are employed by SWCS. Their services are supplied, and the costs recharged, by SWCS to other Group companies including, materially, SWIM. SWIM provides investment management services, and private banking facilities. It generates income through the charging of fund management fees.

14. In 2005 Holdings decided that the Group should pursue a strategy of increasing funds under management by SWIM. That strategy involved the acquisition of discrete fund management units such as the Team. In the instant case the Group intended the Team's customers to become customers of SWIM, and to bring with them the funds under their management. That strategy was the genesis of the transactions with which I am required to deal. The Group considered the funds it wished to acquire to belong to particular teams of individuals at its competitors.

15. Consistently with that approach, in 2005 Viscount Cobham, who was then deputy chairman of Holdings and managing director of the investment management and banking division of the Group, contacted Mr Smiley, as head of the Team at Butterfield, with a view to recruiting the Team.

16. Having agreed terms with the Team, on or about 18 August 2005 SWCS sent an offer of employment to each member of it. On 21 August 2005, Mr Smiley accepted the offer made to him, and on 17 March 2006 he signed a contract of employment. It recorded that his employment commenced on 23 February 2006.

17. The terms which the Group recruited the Team were as follows:

(1) each member was to be employed by SWCS as a director and be paid a market salary, i.e. a salary in line with that of existing employees of SWCS of a similar level of seniority and providing similar services;

(2) each Team member was also eligible to be considered for a discretionary bonus on the same terms as equivalent employees. Mr Smiley was offered a salary of £150,000, and was also eligible to be considered for a discretionary bonus under the arrangements in place for other directors. This bonus policy was said to be commercially competitive, and broadly in line with industry standards;

(3) each contract of employment entered into was on SWCS's standard terms for employees with a similar job description, save that tougher restrictive covenants were imposed; and

(4) Mr Smiley would be invited to subscribe for £10,000 of shares in Smith & Williamson, and would be awarded £10,000 of share options on 1 July or 1 November after the commencement of his employment.

18. In the letter to Mr Smiley, SWIM said, "We have agreed that we will make a payment to you in consideration of the business of any clients you are able to bring to Smith & Williamson after two years' employment."

19. In addition to the offer of employment, by covering letter also of 18 August 2005 SWIM offered to acquire from each member of the Team the right to exploit his or her relationship with private client customers. (For convenience, I shall refer to the entirety of the relationships as "client connections").

20. On 18 December 2006 each member of the Team entered into the 2006 Contract for the transfer of the client connections. Pursuant thereto:

(1) the Team as a whole was to receive, at the end of what the 2006 Contract referred to as "the goodwill period", i.e. the period from 1 November 2005 to 30 April 2008, a "goodwill payment" of 1.5% of "funds under management" as defined in the 2006 Contract less 50% of the amount (if any) by which the expenses, again as defined in the 2006 Contract, exceeded 60% of gross revenues received by SWIM in respect of the funds under management during the goodwill period (the "Payment"); and

(2) the Payment was to be divided among the Team in a manner determined by the Team, subject to the initial control and approval of Mr Pearce, but contractually adjustable by the Team without that control.

21. In the 2006 Contract, "Funds Under Management" are defined as meaning "all funds on all dealing accounts of the Team as at 30 April 2008:

"(i) which are introduced to SWIM by a member of the Team during the Goodwill Period where the Team can demonstrate to the reasonable satisfaction of the Chairman and/or the Deputy Chairman of the Smith & Williamson group that such client had a relationship in respect of the management of funds with

the Team prior to such client entering into an investment management arrangement with SWIM."

22. The terms of the 2006 Contract were negotiated by Mr Smiley and others on behalf of the Team independently of the terms of the contracts of his employment and those of the other members of the Team. In particular, it was not a condition of Mr Smiley's contract of employment by SWCS that SWIM should enter into the 2006 Contract.

23. In due course, the amount of the Payment was determined in accordance with the formula set out in the 2006 Contract at £3,810,000, less an amount that had earlier been paid to Annabel Somers. Annabel Somers left the Team before the Payment was due to be made by SWIM, and received £57,400 under a compromise agreement dated 11 January 2008. In a letter of 22 December 2008 to HMRC, SWIM explained that £57,300 was paid in respect of her loss of office and "there [was] no element of goodwill". The remaining £100 was expressed to be for a restrictive covenant.

24. On 24 July 2008, SWIM wrote to Mr Smiley saying, "We have now agreed that the Goodwill Payment due under our 2006 agreement amounts in total to £3,810,000 of which your share is £957,295.92". Other members of the Team received letters in similar form, but of course with the share in question differing.

25. An interim payment of £875,000 was made to Mr Smiley on 30 June 2008, and the balance of £82,295.92 was paid to him on or before 24 July 2008.

26. On making the Payment, which amounted to £3,752,595, SWIM, on the advice of its accountants, Deloitte & Touche ("Deloittes"), capitalised its total as expenditure on goodwill. SWIM adopted similar accounting treatment in respect of payments it made for other business units. Subsequently, in 2010, on review, it reclassified the client connections as "client relationships", and decided to amortise them on a straight line basis over a ten year period from the date on which the goodwill had been recognised consistently with International Financial Reporting Standard 3 (2008). SWIM claims to have correctly done so for, had the Payment been in respect of emoluments, the proper accounting treatment thereof would have been to write it off in the year in which it was made.

27. Most helpfully, Mr Maugham suggested that it may be helpful in making my findings if I were to answer the following questions of fact:

(1) What was the Group's strategy in relation to the recruitment of the Team and the acquisition of the Team's book of business i.e. client connections?

(2) What was the Payment perceived as being for?

(3) Did the Team have an asset to sell?

(4) What was the relationship between the Payment and remuneration from the employment?

(5) What do the terms of the 2006 Contract tell one about the source of the Payment?

(6) What happens if HMRC's earn-out criteria are applied to the present facts?

(7) Did the Group's strategy succeed?

(1) What was the Group's strategy in relation to the recruitment of the Team and the acquisition of client connections?

28. The Group was formed from a merger of NCL Securities Limited and Smith & Williamson in 2002. On formation, the Group embarked on a long-term strategic plan to increase market share in each of its main areas of activity, and particularly in the private client investment management sector. The Group, and relevantly SWIM, sought to increase private clients' funds under management mainly through a series of acquisitions of business units. As Mr Pearce explained in cross-examination:

> "… you have to invest heavily in systems and processes, … [and] in a regulatory structure, and that does give an advantage to the larger firms who can afford to do this in a first class way. So we could see that, … if we could grow our funds under management we could make a business substantially more profitable, and that is exactly what Chris Cobham [Viscount Cobham] and I initially discussed back in 2002 …"

29. Mr Pearce added that SWIM's purpose was to increase funds under management rather than to recruit additional fund managers. Between 2003 and 2005, SWIM had sufficient front and back office capacity to cope with at least an additional £1.5 billion of funds under management. As Mr Pearce put it:

> "Talented fund managers are always a scarce commodity and, were the right individual to become available, we would seek to attract him or her regardless. But what we really wanted from the teams we were interested in was the funds under management that they could bring with them; we already had the capacity to service those funds".

30. Pursuant to that strategy, which I find to have been that of the Group in addition to the Team SWIM acquired other business units in Glasgow, Birmingham and Bristol, on similar terms to the acquisition of the Team.

(2) What did SWCS perceive the Payment to be made for?

31. From the perspective of each of the Group, the Team, the Group's accountants, Deloittes, and its lawyers, Taylor Wessing, the Payment was perceived as being made for an asset.

The Group's perspective

32. The Group's perception was broadly that set out in answer to the question at (1) above, and the strategy underpinning the Payment was to increase the funds it held

under management, with the aim of improving margins rather than recruiting additional front office staff. I so find.

The Team's perspective

33. Mr Smiley understood the Payment to consist of a capital sum for the acquisition of client connections, as distinct from the remuneration (which included a full package of basic salary, discretionary bonus and a long term share incentive plan) as set out in his contract of employment and those of the other members of the Team. The Group had clearly indicated to him that it was interested in buying the book of business that the Team had built up, and was prepared to discuss how such a purchase might be achieved. Mr Smiley consistently understood such discussions to be separate from negotiations relating to the particular terms of contract of employment.

The Accounting Perspective

34. The Group sought independent advice from Deloittes in 2006 to determine the appropriate accounting treatment of the Payment. Deloittes initially advised that the acquisition of client connections and the Payment should be treated as a business combination under IFRS 3 and that:

> "In accordance with IFRS 3.24 and 37, on the date of acquisition of the teams, the Company should recognise the fair value of any asset, liabilities or contingent liabilities relating to the team in its consolidated balance sheet. This includes recognising any intangible asset that are [sic] separable and where a fair value can be measured reliably … However, contingent costs should exclude costs expected to be incurred as a result of a combination, including future remuneration for services to the Company as employees".

35. That approach was reflected in SWIM's audited accounts for the 2007 financial year, which showed an increase in "Intangible assets" from £1,385,731 in 2006 to £3,715,264. The relevant explanatory note reads:

> "During the year ended 30 April 2006, a number of investment managers were employed and it was agreed to make payments to them based on the value after a period of certain categories of funds under management introduced by them to the company. … As at 30 April 2007, an estimate of £2,983,534 has been made on the contingent cost under these arrangements. This amount has been recognised in the financial statements as an addition to goodwill ….

36. Subsequently, in 2010, following changes made to the incorporation in accounts of intangible assets, client connections were reclassified in SWIM's audited accounts as "client relationships" and it was decided to amortise them on a straight line basis over a ten year period from the date on which the intangible asset had been recognised.

The Group's legal advisers' perspective

37. Prior to recruitment of the Team, the Group's legal advisers, Taylor Wessing, noted that such recruitment could constitute a transfer of an undertaking within the meaning of the Transfer of Undertakings (Protection of Employment) Regulations 2006 and that, accordingly, the Group ran the risk of being obliged to offer employment to all 24 of the personnel then employed at Butterfield – and not just the members of the Team.

(3) Did the Team have an asset to sell?

38. The evidence, in summary, demonstrated:

> (1) that some of the clients who followed Mr Smiley from Panmure Gordon to Leopold Joseph & Sons Ltd remained clients of his on the sale of the latter company to Butterfield. They then followed him from Butterfield to SWIM; and
>
> (2) that the Team was able to deliver its clients to SWIM and that, once there, they did not follow those members of the Team who subsequently moved on.

39. Mr Smiley claimed, and I accept, client connections to be best understood as a "book of business" composed of a set of client relationships built over time by the Team individually and collectively at Panmure Gordon, Leopold Joseph & Sons Ltd and Butterfield. Mr Smiley explained:

> "Fund managers had direct responsibility not only for the investment management decisions taken in respect of client funds, but also had direct responsibility for maintaining the relationship with client investors … I had built up valuable connections from the long standing client relationships with those clients for whom I had direct responsibility. Similarly, the other senior members of the Team … had also built up valuable connections with those investors for whom they had the relationship responsibility".

40. Mr Smiley explained those relationships to be so strong that members of the Team gave serious consideration to setting up a fund management business of their own.

41. In the event, approximately £200 million of funds under management had followed the Team from Butterfield to SWIM by the end of May 2006, and 314 new investment management agreements had been signed by former Butterfield clients during the same period, with that number increasing to 494 by April 2008. On that basis, Viscount Cobham claimed, and I accept, the evidence to show that over 90 per cent of the Butterfield clients, representing 80-85% of client connections under management, followed the Team to SWIM.

42. SWIM took the following steps to ensure that clients of the Team would remain with it rather than follow any departing member of the Team:

(1) Senior members of the Team contractually agreed: (a) that they could be put on gardening leave for six months (during the course of which they could be *inter alia* precluded from having any dealing with clients of SWIM); and (b) to restrictive covenants, which provided similar restrictions on contacting or accepting business from SWIM's clients or potential clients. Effectively, the Group ensured that, in the event of the departure of a Team member, it had the contractual right to put that member "out of the market" for a year to minimise any risk of client relationships moving from SWIM.

(2) The Team did not service all the client relationships it transferred to SWIM. As Mr Smiley explained, "certain funds which moved with the Team were transferred by [SWIM] to other existing teams at the firm, to be managed by those teams".

(3) SWIM absorbed the Team into the company, such that it ceased to exist as a separate business unit. Viscount Cobham implicitly indicated that to mean that any repetition of the mass exodus of clients from Butterfield became impracticable.

43. I accept the evidence to show that strategy to have been successful. Client relationships, including client connections, once acquired by SWIM, tended to remain with it, notwithstanding staff turnover in the various investment management teams or, indeed, the departure of individual members of the Team. As Mr Pearce explained:

> "Since the payment was made two team members have ceased employment with Smith & Williamson. Sophia Chambré (nee Calvert) left the firm in April 2009. … We are not aware of any of the clients that Sophia Chambré helped to introduce through her pre-existing client relationships followed her when she left. Mark Boucher left in August 2008 and none of his clients (either those that he introduced from his pre-existing relationships before he joined or those acquired through his efforts whilst with Smith & Williamson) have left to follow him".

(4) What was the relationship between the Payment and remuneration from the employment?

44. The evidence relied on by SWCS as demonstrating that the Payment was inconsistent with its being from the employment of the Team consisted of the following factors:

(1) Two separate and independent contracts were drawn up. The first was a contract of employment between each member of the Team and SWCS on the latter's standard and commercially competitive market terms. The second was the 2006 Contract between the Team and SWIM setting out the basis upon which the Payment would be made and calculated.

(2) Negotiations for the contracts of employment and those for the Payment itself were conducted independently. As Mr Smiley put it:

> "[the] discussions regarding the payment to be made for acquisition of [client connections] were separate from the discussions of the particular terms of my own employment contract".

Those negotiations were conducted over different time frames. Mr Smiley ultimately signed his contract of employment on 17 March 2006 but the 2006 Contract was signed on 18 December 2006.

(3) The sums payable under each of the contracts of employment, on the one hand, and the 2006 Contract, on the other, were market rate sums calculated by parties at arm's length and on arm's length terms.

(4) Moreover, the 2006 Contract was made some time after the contracts of employment had been signed.

(5) The Payment was calculated by reference to client connections as delivered by the Team (rather than any single member thereof) and was apportioned among the members of the Team as Mr Smiley determined in consultation with its other members. Mr Pearce observed that those proportions were not determined by the Group, which merely retained an initial supervisory right to secure that such apportionment was effected in a relatively equitable and democratic manner – a right that was not exercised. Even had it been, the Team retained the right to alter the proportions in which the Payment would be received after that supervisory right had been exercised. As Viscount Cobham explained in evidence:

> "[A.] Well, because the goodwill payment was a payment to the Team for the delivery of a business that we wanted to take forwards. So we, as Smith & Williamson, weren't too worried, we didn't know necessarily what the right split would be, it was the business, and the business was determined by the team who were bringing business over.
>
> [Q.] … would it be fair to say that it was for you to decide what the aggregate amount was?
>
> [A.] Correct
>
> [Q.] But for them to decide how the payment should be split as between the team members?
>
> [A.] Correct".

(6) The 2006 Contract provided that "qualifying funds" for the purposes of the calculation of quantum of the Payment were only those transferred with the Team. Client relationships introduced by the Team from other sources (that is, new clients won by the Team subsequent to the commencement of their employment with the Group) were not "qualifying funds" for the purposes of the determination of the Payment.

(7) Moreover, the Payment was made irrespective of whether the Team serviced the client funds under management transferred to SWIM with client connections. The Payment was computed on the basis of the value of "Funds Under Management", which for the purposes of the 2006

Contract were defined with reference to the funds which "are managed by [SWIM]" (as opposed to the Team) at the end of the goodwill period. Notably, Mr Pearce said:

> "Some sixteen separate funds of clients who had been clients of the team at the Bank of Butterfield had not continued to be looked after by the Team after the Team joined Smith & Williamson. If the funds 'qualified', however, we were bound to pay for them, nevertheless".

(8) Annabel Somers left the employment of SWCS before the end of the goodwill period. Although under the terms of the 2006 Contract, she had no contractual entitlement to any part of the Payment, she nevertheless received a payment of £57,400 In a letter to her of 6 December, the Group said that it "believed [the Payment] to represent a generous offer given that you have no legal entitlement to any part of the Goodwill Payment having tendered your notice". Subsequent to the buy-out of her share, the amount of the Payment payable to the rest of the Team was reduced. I find that the share of the Payment paid to her could not have been for her service as an employee.

45. One basis which might indicate that the Payment was from Mr Smiley's employment with SWCS was clause 5 of his employment contract which provided that:

> "you shall … carry out your duties in a proper, loyal, careful, skilful and efficient manner to the best of your ability and use your best endeavours to maintain, develop and extend the business of the Company and the group and not to act in any manner whatsoever to its detriment".

46. However, Mr Pearce explained that the Team's reward for attracting new clients under the SWCS contract of employment lay in a deferred share and discretionary bonus plan:

> "We do, of course, expect all of our fund managers to try to attract new clients with funds under management to Smith & Williamson. An individual who achieves a net increase of funds under management, measured over the firm's financial year, which is in excess of the hurdle (£15 million up to April 2012) is further rewarded for the achievement under a deferred share plan. If the hurdle is achieved the fund manager is awarded £1,000 of Smith & Williamson shares for each £1 million of net increase and those shares vest rateably over a period of three years. The efforts of those who achieve a net increase in funds under management in a financial year that falls below the hurdle rate for the deferred share plan are recognised when decisions are made annually concerning discretionary performance bonuses, subject to the comments made above concerning profitability of their business division. Those bonus arrangements apply to all fund mangers and this sort of 'organic' growth in funds under management achieved by team members is certainly not part of the 'Qualifying funds' introduced for the purposes of quantifying the capital payment, whatever the level or return by way of fee and commissions".

(5) What do the terms of the 2006 Contract tell one about the source of the Payment?

47. A number of points emerged from the evidence on the 2006 Contact which might cast light on whether the Payment (properly analysed) could be said to be from employment. The points on which SWCS relies are those which follow:

(1) The 2006 Contract was with SWIM and not with SWCS. The Payment was made under the 2006 Contract and not the contract of employment with SWCS.

(2) The Payment was made to the Team, and (subject to the initial supervisory control of Mr Pearce but, subject also to the Team's subsequent right to alter the proportions thereof) it was for the Team to decide how the Payment should be shared among them. So if, hypothetically, one member of the Team did absolutely nothing at all, the Team could still have decided he was to receive 100% of the Payment. Equally, if, say, Mr Smiley brought over all of the clients (and so personally delivered all of the funds under management to SWIM) the Team could still have decided that he got nothing.

(3) The Payment was calculated by reference to funds under management at the end of the goodwill period. They were defined as the funds under management the Team brought over from Butterfield to SWIM. So the Payment was calculated by reference to the success of the collective Team effort rather than any individual performance.

(4) The Payment was calculated by reference to a snapshot (at the end of the goodwill period) of the fund the Team successfully brought over – not the funds the Team managed or continued to manage. The payment was not for managing funds. As Viscount Cobham put the matter in evidence:

> "[Q.] Again looking at the income line, does the payment reflect the team's success in bringing the funds over or the team's success in managing the funds?
>
> [A.] The team's success in bringing the funds over, I mean, that was the whole purpose of the goodwill payment."

(5) Members of the Team were rewarded for managing funds well. However, the evidence indicated that that was under their contracts of employment:

> "[Q.] Now, the other separate question which I have is you said in the discussion with my learned friend Ms Hodge that if they, the team members, retained their clients their revenue, their earnings from employment, would increase over the years.
>
> [A. Viscount Cobham] Correct.

[Q.] Can you elaborate upon what you mean by that?

[A.] Yes. If you take two teams, one producing a million and one producing £2 million, typically the one producing two million, if it was the same number of people and the same direct costs associated with the team, would be greatly more profitable and their share of the two million would be relatively higher than the team sharing in the revenue attached to just one million, because provided that you can give the people the wherewithal to be able to service those clients, then they can build the book of business that the revenue is associated with, which will have a very profound effect on their earning capacity. Whereas if they are working somewhere where they don't feel it easy to develop and to build their business, they will have a lid on their earning capacity.

[Q.] And implicit in your answer is the proposition, is it, that one of the ways in which you become the more profitable £2 million team is by managing your clients well?

[A.] Correct. That will also develop the referral business that comes in."

(6) The Payment was a one-off payment calculated by reference to funds under management at a particular point in time. It was not an on-going payment for services under a contract of employment.

(7) If a Team member were to leave before the end of the Goodwill Period, the "Expenses" element of the goodwill payment calculation would decrease and so the Payment would or could rise. Consequently, the Payment involved a contingency which (at a minimum) had nothing to do with the employment status of the recipient of the Payment and (at most) was inconsistent with the Payment being from the employment of the Team. Moreover, if a Team member left before the end of the goodwill period, his share would be distributed amongst the remaining members of the Team. So the Payment involved a further contingency which (at a minimum) had nothing to do with the employment status of the recipient of the Payment and (at most) was inconsistent with the Payment being from the employment of the Team.

(8) The Payment accrued to Team members employed at the end of the goodwill period (i.e. 30 April 2008), even if they subsequently left prior to the payment date of 30 June 2008.

(6) What happens if HMRC's earn-out criteria are applied to the present facts?

48. HMRC's Employment Related Securities Manual ("ERSM"), at paras 110900 to 110940, which addresses the situation where an individual sells his business (or his shares in a business) and is employed by the purchaser for an "earn out" period during which the amount of his consideration, contingent on the performance of the business,

and indicates how it is to be calculated. The question which arises in such circumstances is how much of the contingent consideration is, properly analysed, for the business (taxable at a (lower) rate of capital gains tax) and how much is, properly analysed, earnings from his on-going employment (tax at a (higher) rate of income tax).

49. At ERSM 110940 the Manual provides as follows:

> *"Key indicators in determining whether an earn-out is further sale consideration rather than remuneration are:*
>
> *a. The sale agreement demonstrates that the earn-out is part of the valuable consideration given for the securities in the old company*
>
> *b. The value received from the earn-out reflects the value of the securities given up.*
>
> *c. Where the vendor continues to be employed in the business, the earn-out is not compensation for the vendor not being fully remunerated for continuing employment with the company.*
>
> *d. Where the vendor continues to be employed, the earn-our is not conditional on future employment, beyond a reasonable requirement to stay to protect the value of the business being sold.*
>
> *e. Where the vendor continues to be employed, there are no personal performance targets incorporated in the earn-out.*
>
> *f. Non-employees or former employees receive the earn-out on the same terms as employees remaining.*
>
> *The following factors may also be relevant:*
>
> …
>
> *Evidence that future bonuses were reclassified or commuted into purchase consideration would indicate that the earn-out was, at least partly, remuneration rather than consideration for the disposal of securities.*
>
> *Where the earn-out is partly deferred consideration for the old securities and partly a reward for services or inducement to continue working for the business, then an apportionment of the value will need to be undertaken on a just and reasonable basis.*
>
> *This guidance is only applicable to the computation of earnings under Chapter 2, 3, or 5 Part 7 ITEPA 2003 and has no bearing on the rules for Capital Gains Tax."*

(On the facts of the present case, factors g and h are inapplicable.)

(7) Did the Group's strategy succeed?

50. The Group's strategy met with considerable commercial success. SWIM's funds under management had increased from £5.4 billion in 2004 to £12.1 billion in 2012, and operating margins in the investment division improved from 17 per cent in 2004 to 26 per cent in 2011. SWIM considered that it had recovered the cost of acquiring client connections by May 2010. The acquisition of client connections went, as Mr Pearce put the matter in cross-examination, "better than expected".

51. Rates of management utilisation likewise increased significantly in response to SWIM's management overcapacity issues. Minutes from a SWIM board meeting held on 20 March 2008 confirmed that the gap between the annualised basis point return of SWIM compared to one of its major competitor, Rathbones – a deficit first evidenced in March 2007 as being very wide – had been "virtually eradicated".

52. I accept that the Group's strategy did succeed.

The Law

Capital Gains Tax

53. Although nor directly relevant, even though HMRC accept that in the event I were to find that the Payment was not liable to income tax, I find it helpful to include the definition of assets for capital gains tax purposes as indicating that it extends to property coming to be owned without being acquired. Assets are defined in s.21 Taxation of Capital Gains Act 1992 as follows:

> "21 Assets and disposals
>
> (1) All forms of property shall be assets for the purposes of this Act, whether situated in the United Kingdom or not, including –
>
> (a) options, debts and incorporeal property generally, and
>
> (b) currency, with the exception (subject to express provision to the contrary) of sterling,
>
> (c) any form of property created by the person disposing of it, or otherwise coming to be owned without being acquired."

Income Tax

54. The taxation of employment income is dealt with by s.9 of the Income Tax (Employment and Pensions) Act 2003 ("ITEPA") which provides:

> "(1) The amount of employment income which is charged to tax under this Part for a particular tax year is as follows.

(2) In the case of general earnings, the amount charged to tax is the net taxable earnings from an emolument in the year.

(3) That amount is calculated … by reference to any taxable earnings from the employment in the year.

…

(6) Accordingly, no amount of employment income is charged to tax under this Part for a particular year unless –

(a) in the case of general earnings, they are taxable earnings from an employment in that year, or

(b) in the case of specific employment income, it is taxable specific income from an employment for that year."

55. For these purposes s. 62(2) of the ITEPA provides that "earnings" in relation to an employment means:

(a) any salary, wages or gee;

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

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

56. The amount of a person's "taxable earnings" in a given year it is to be determined in accordance with Chapters 4 and 5 of Part 3 ITEPA 2003 (see s. 10(2) ITEPA 2003). Where a taxpayer is resident in the UK for a given year he is liable for income on the full amount of any general earnings which are received in the year (see s. 15(2) ITEPA 2003), which are "from" the employment (s. 9(2) ITEPA 2003).

National Insurance Contributions

57. Liability for NIC purposes is dealt with by ss. 3 and 6 of the Social Security Contributions and Benefits Act ("the Contributions Act"). Section 6(1) provides for such contributions to be payable where in any tax week earnings are paid to or for the benefit of an earner. Section 3(1) provides that:

"In this Part of this Act and Parts II to V below –

(a) 'earnings' includes any remuneration or profit derived from an employment; and

(b) 'earner' shall be construed accordingly."

58. For the purposes of s. 6 of the Contributions Act the Payment, it is liable to tax as earnings, is also liable to NICs as being "earnings … derived from an employment".

59. It is common ground that the test to be applied for NICs is, in substance, the same as that under s.9 of the 2003 Act.

The PAYE Code

60. Pursuant to Chapter 1 Part 11 ITEPA an employer is required to administer the Paye As You Earn code in respect of certain types of income, including so-called 'PAYE employment income' in any given year (see s. 683 ITEPA). And at section 683 ITEPA, relevantly:

> (1) For the purposes of this Act and any other enactment (whenever passes) "PAYE income" for a tax year consists of –
>
> (a) any PAYE employment income for the year …
>
> (2) "PAYE employment income" for a tax year means income which consists of –
>
> (a) any taxable earnings from an employment in the year (determined in accordance with section 10(2)), and
>
> (b) any taxable specific employment income from an employment for the year (determined in accordance with section 10(3)).

Since "PAYE employment income" includes any income which consists of any taxable earnings from an employment in the year which fall within s. 10(2) ITEPA 2003 (see s. 683(2)(a) ITEPA), it follows that if, contrary to Mr Smiley's case the sums in point do consisted "general earnings" from his employment for the year ended 5 April 2007, then they would have constituted PAYE Employment Income within the meaning of s. 683(1)(a) ITEPA.

The PAYE Code

61. At the material time, reg 68 of the Income Tax (Pay As You Earn) Regulations 2003 ("the 2003 Regulations") required an employer to make deductions from relevant payments made to employees. Pursuant to reg 69 of the 2003 Regulations an employer was obliged to pay that amount deducted to HMRC within a specified period (see s. 69(1) ITEPA).

62. The provisions of reg 80(1) of the 2003 Regulations enable HMRC to issue a determination to an employer in circumstances where an amount payable under reg 68 of the 2003 Regulations has not been paid. So far as is relevant at the material time the provisions of reg 80 of the 2003 Regulations provided as follows:

> "80 Determination of unpaid tax and appeal against determination
>
> (1) This regulation applies if it appears to HMRC that there may be tax payable for a tax year under regulation 76G or 68 by an employer which has neither been –
>
> (a) paid to HMRC, nor
>
> (b) certified by HMRC under regulation 75A, 76, 77, 78 or 79.
>
> (1A) In paragraph (1), the reference to tax payable for a tax year under regulation 67G includes a reference to any amount the employer was liable

to deduct from employees during the tax year whether or not that amount was included in any return under regulation 67B (real time returns of information about relevant payments) or 67D (exceptions to regulation 67B).

(2) HMRC may determine the amount of that tax to the best of their judgment, and serve notice of their determination on the employer.

(3) A determination under this regulation must not include tax in respect of which a direction under regulation 72(5) has been made; and directions under that regulation do not apply to tax determined under this regulation.

(3A) A determination under this regulation must not include tax in respect of which a direction under regulation 72F has been made.

(4) A determination under this regulation may –

(a) Cover the tax payable by the employer under regulation 67G or 68 for anyone or more tax periods in a tax year, and

(b) Extend to the whole of that tax, or to such part of it as is payable in respect of –

(i) a class or classes of employees specified in the notice of determination (without naming the individual employees), or

(ii) one or more named employees specified in the notice.

(5) A determination under this regulation is subject to Parts 4, 5, 5A … and 6 of the TMA (assessment, appeals, collection and recovery) as if –

(a) the determination were an assessment, and

(b) the amount of tax determined were income tax charged on the employer,

And those Parts of that Act apply accordingly with any necessary modifications."

63. The reg 80 Determinations under appeal were issued pursuant to the provisions of reg 80(1) of the 2003 Regulations. Pursuant to reg 80(5) of the 2003 Regulations SWCS brought its appeal pursuant to s. 31 TMA.

Interaction of PAYE and self-assessment

64. Save in exceptional circumstances, the liability for unpaid PAYE rests with an employer who fails to deduct the correct amount of tax under the PAYE code, and not with the employee. This follows from the provisions of reg 185 of the 2003 Regulations which provides as follows:

"185. Adjusting total net tax deducted for purposes of s. 58A(1) and 59B(1) TMA

(1) This regulation applies for the purpose of determining –

(a) The excess mentioned in section 59A(1) of TMA (payments on account of income tax: income tax assessed exceeds amount deducted as source), and

(b) The difference mentioned in section 59B(1) of TMA (payments of income tax and capital gains tax: difference between tax contained in self-assessment and aggregate of payments on account or deducted at source).

(2) For those purposes, the amount of income tax deducted at source under these Regulations is the total net tax deducted during the relevant tax year ("A") after making any additions or subtractions required by paragraphs (3) to (5).

(3) Subtract from A any repayments of A which are made before the taxpayer's return and self-assessment is made under section 8 or 8A of TMA (personal return and trustee's return).

(4) Add to A any overpayment of tax from a previous tax year, to the extent that it was taken into account in determining the taxpayer's code for the relevant tax year.

(5) Add to A any tax treated as deducted, other than any direction tax, but

(a) only if there would be an amount payable by the taxpayer under section 59(B)(1) of TMA on the assumption that there are no payments on account and no addition to A under this paragraph, and then

(b) only to a maximum of that amount.

(6) In this regulation –

'direction tax' means any amount of tax which is the subject of a direction made under regulation 72(5), regulation 72F or regulation 81(4) in relation to the taxpayer in respect of one or more tax periods falling with the relevant tax year;

'relevant tax year' means –

(a) In relation to section 59A(1) of TMA, the immediately preceding year referred to in that subsection;

(b) In relation to section 59B(1) of TMA, the tax year for which the self-assessment referred to in that subsection is made;

'tax treated as deducted' means any tax which in relation to relevant payments made by an employer to the taxpayer in the relevant tax year –

(c) The employer was liable to deduct from payments but failed to do so, or

(d) The employer was liable to account for in accordance with regulation 62(5) (notional payments) but failed to do so;

'the taxpayer' means the person referred to in section 59A(1) or the person whose self-assessment is referred to in section 59B(1) of TMA (as the case may be)."

65. In those circumstances the amount of PAYE tax deductible by SWCS in respect of Mr Smiley pursuant to the terms of the regulation 80 determination (insofar as it relates to Mr Smiley) was the amount of "tax treated as deducted" within the meaning of reg 185(6) of the 2003 Regulations. The effect of reg 185(5) of the 2003 Regulations is that the amount of tax assessed under reg 80 determination in respect of Mr Smiley is deemed for the purposes of s. 59B(1) TMA to constitute an amount of tax that has been deducted at source.

Submissions for HMRC

66. Ms Hodge submits that the Payment was earnings within s.62 ITEPA from the Team members' employment with SWCS. Therefore:

1. they were chargeable to tax in the hands of the Team members as employment income within s.6 ITEPA, and not as chargeable gains.

2. they were earnings within s.3(1)(a) of the Contributions Act and SWCS was liable to pay NICs by virtue of s.6 of the Contributions Act.

   2.1. Earnings are defined in s.3(1)(a) of the Contributions Act as including "any remuneration or profit derived from an employment." That is so similar to the meaning of "earnings" and "from the employment" in ITEPA as to mean that it is unnecessary to draw any difference of interpretation between the meanings for the purposes of these appeals.

   2.2. If the Payments are found to be earnings from the employment for income tax purposes, then they are also earnings for NIC purposes.

3. The Payment was PAYE income within s.683 ITEPA on which SWCS was liable to deduct tax in accordance with the 2003 Regulations and to pay that tax to HMRC.

4. SWCS should have accounted for the NICs on the Payments in "like manner" as the PAYE income (reg 67 of the Social Security (Contributions) Regulations 2001)."

Employment income

67. Ms Hodge also submits that the Payment was chargeable to tax as employment income, not as a chargeable gain, because it was earnings from the Team's employment with SWCS.

68. She maintains the Payment to be employment income and chargeable to income tax under s.6 ITEPA because:

> 1. it was earnings that is to say a "profit or incidental benefit of any kind obtained by the employee … or … emolument of the employment" within the meaning of s. 62(2) ITEPA; and
>
> 2. it was received "from" the employment (s.9(2) ITEPA).

69. The significance of the words "from employment" illustrated the principles expressed by those words in the ITEPA. As Ms Hodge explains, the relevant authorities were discussed in *Shilton v Wilmshurst (Inspector of Taxes)* 64 TC 78 ("the *Shilton* case") and convey the principle that a payment was earnings from employment if its source was an individual's existing, continued or future employment and nothing else. She adds that the *Shilton* case also demonstrates that earnings from employment were not restricted to payments made in return for the performance of services.

70. At p.107A of the *Shilton* case, Lord Templeman cited Lord Radcliffe in *Hochstrasser v Mayes* 38 TC 673 (1960):

> "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."

71. At p. 107G Lord Templeman cited Lord Reid in *Laidler v Perry* 43 TC 351 (1966) who identified the question to be answered in all cases such as the present one as:

> "… did this profit arise from the employment? The answer will be no if it arose from something else."

72. In the case of *Kuehne & Nagel Drinks Logistics Ltd and others v HMRC* [2012] EWCA Civ 34, Mummery LJ observed at paragraph 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."

73. And, with regard to the interpretation of the statutory language, Mummery LJ added at paragraph 33:

> "All I need say at this point is that the use of "from" in the ideal expressed in the statutory expression "earnings from an employment" and "earnings derived from an employment" in a fiscal context indicates, as a 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."

74. Ms Hodge submits the relevant connection between the Payment to the Team members and their employment to be plain on the facts of the present case. The Payment did not arise "from something else"

75. She also submits the Payment to be earnings from the Team's employment because it rewarded its members for successfully exploiting, on behalf of SWIM and in the performance of their duties of employment with SWCS, and their personal connections with clients known to them by reason of their former employment. The Payment arose from their employment and from nothing else.

76. The Payment was made, in addition to a Team member's salary, to reflect the extra income/profits generated by reference to previous business contacts. Expressed in the terms used by Mr Pearce and Viscount Cobham in evidence, Ms Hodge maintains that it was the reward for establishing funds under management, as hoped for and expected by SWIM, and by exploiting client relationships that existed by virtue of the Team members' previous employment.

77. The 2006 Contract was an adjunct to the Team's employment contracts and provided for additional remuneration that might be earned in particular circumstances.

78. The formula for calculating the amount of the Payment was clearly structured to encourage the Team, whether acting individually or together, to bring new business to SWIM by drawing on pre-existing contacts to persuade clients of their former employer to switch investment management arrangements to SWIM. Whilst that required them to draw on relationships developed over an earlier period, Ms Hodge maintains the attraction of new business to SWIM to be part of the performance of the duties of their employment. Furthermore, the formula depended on the retention of that new business (and the Team's continued employment) through to 30 April 2008, once again by virtue of the performance of the duties of the employment.

79. She does not agree with Mr Smiley's evidence and Mr Maugham's contention that the Payment was made for the acquisition of the right to exploit client relationships, claiming it to be a reward for the Team's services and not "for something else".

80. Contrary to both appellants' contentions, Ms Hodge further submits that, in accordance with the agreements between SWIM and the individual Team members the Payment was made to each Team member, not the Team as a whole. It was clear from the 2006 Contract in respect of Mr Smiley and from SWIM's letter of 18 August 2005 to Mr Smiley which said "We have agreed that we will make a payment to you in consideration of the business of any clients you are able to bring to Smith & Williamson after two years' employment", that SWIM contracted with the individual Team members and not the Team as a whole.

81. The fact that the Team members had the right, if certain conditions were fulfilled, to amend the percentage of the Payment to which they were entitled, was no barrier to the Payment being from their employment.

82. Ms Hodge maintains, in contrast to a claim by Mr Smiley, that it was not noteworthy that the 2006 Contract did not require all of the Team members to continue to be employed by SWCS at the time the Payment was made. The 2006 Contract was between Mr Smiley and SWIM so one would not expect conditions relating to other Team members to be present in his contract.

83. Annabel Somers left the team before the Payment was due to be made and received £57,400 under a compromise agreement dated 11 January 2008. Ms Hodge contends that that sum was not paid under the 2006 Contract. The letter of 22 December 2008 to HMRC explained that the payment was made in respect of loss of office and "there [was] no element of goodwill". Also, paragraph 3 of the compromise agreement between Ms Somers and SWCS showed £57,300 of the sum to be for loss of office and the remaining £100 to be for a restrictive covenant. Ms Hodge submits that that supported HMRC's view that the Payments were from the employment.

84. The amount SWIM had treated as an intangible asset was the £3,752,595 paid to the remaining members of the Team rather than the £3,810.000 which would have included the £57,400 paid to Annabel Somers under the compromise agreement.

85. Of a submission by Mr Maugham that, even if the Payment was from the employment it was not taxable under ITEPA or the Contributions Act because it was from the disposal of a capital asset, Ms Hodge submits the Payment to be from the employment and not in respect of SWIM's purchase of an asset, capital or otherwise, from the Team. She so submits since:

1. The 2006 Contract made no mention of the sale of anything from Mr Smiley to SWIM.

2. In their evidence the witnesses for the appellants referred to the Payment as being capital but its character was a question of law not of fact. Their evidence to that effect therefore bore no weight.

3. The Payment fell due as a lump sum (although in fact it was paid in two instalments). The statutory test for whether an amount payable as a lump sum was chargeable to tax as employment income was not concerned with a distinction between capital and revenue, but was whether the amount was "from the employment".

4. Contrary to the assertions made in the appellants' evidence, the Team did not own the client relationships either individually or collectively. SWIM now had clients with funds under its management who were previously clients of Butterfield. But it did not acquire the book of funds from the Team because it was not an asset that the Team had to sell. The Team had nothing to sell but its members' services and, in the context of employment, the reward for services was remuneration. In Ms Hodge's further submission, the true situation was described by Mr Smiley in the following way:

"After [I] joined SWIM in February 2006 funds of clients of [Butterfield] business soon followed to SWIM". And in Deloittes' accounting advice to SWIM (given just before the 2006 Agreement was signed) they stated in relation to the Team (and the new Glasgow team) that:

> "… the teams brought with them skills in generating new customer relationships and also existing relationships with customers."

5. Mr Pearce maintained that SWIM wanted the funds under management by Butterfield rather than wanting to acquire the Team members. But Ms Hodge submits, that does not support the appellants' contention that the Payment was for the acquisition of an asset rather than being from employment. SWIM actually acquired the funds under management by Butterfield by means of employing the Team, even though it had the capacity to service any funds acquired under the 2006 Contract without the Team.

6. Ms Hodge rejects the appellants' claims that the following facts show the Payment to have been made for the acquisition of an asset rather than being from employment.

a. That the Payment was negotiated and made pursuant to a separate contract from the Team's employment contracts.

b. That the amount of the Payment was contingent on how client connections performed rather than on personal performance targets.

c. That the Payment was additional to Mr Smiley's contractual salary, bonus and pension- a remuneration package that was a significant improvement over the terms of his employment by Butterfield.

d. That the Payment was made in relation to clients attracted from Butterfield and other arrangements were made to remunerate the Team for acquiring new clients from other sources

e. The length of the "goodwill period".

f. That the Payment was calculated on the funds under management brought over by the Team, even if the Team did not manage those funds at the end of the goodwill period.

g. That SWCS did not require Mr Smiley to enter into the 2006 Agreement as a condition of his employment.

86. She also rejects the contention of Mr Maugham that the cases of *Tilley v Wales* [1943] AS 386 and *Mairs v Haughey* 66 TC 273 supported the contention that the Payment was not in respect of remuneration for any services supplied, on the basis that the facts of those cases were completely different from those in the current appeals and the reasons for the decisions were therefore inapplicable.

Accountancy

87. Ms Hodge observes that HMRC do not dispute that the Payments were correctly capitalised in SWIM's accounts, but submits that the fact that SWIM acquired an intangible asset for accountancy purposes did not necessarily mean that it had purchased an investment business or client relationships from Butterfield or the Team. Both Mr Pearce and Viscount Cobham admitted the Group never intended to purchase an asset from Butterfield. Rather SWCS's intention was to achieve the same effect, as far as possible, by a different strategy.

88. The accounting definition of a business referred to inputs, processes and outputs of an integrated set of activities. There was no evidence that SWIM had, in legal form rather than as a matter of accounting policy, purchased an existing intangible asset from a third party.

89. Ms Hodge further maintains that it is irrelevant that SWIM's accounts show the Payment to be an intangible asset. SWIM was concerned with the tax treatment of the Payment in the hands of the recipients and the consequences of that treatment for the payer in terms of the requirement for the operation of PAYE. That did not necessarily follow the accountancy treatment – a view supported by Smith & Williamson's memorandum of 5 July 2010 to the Audit Committee in respect of Accounting for Goodwill which said at paragraph 8.6:

> "… the Birmingham teams have had the acquisition of their intangible assets treated as remuneration in their hands for income tax purposes, which has been subject to PAYE and NIC. It is our view that this would not prevent the company treating this as an intangible asset for accounting purposes and obtaining relief for amortisation if this asset meets the accounting definition".

90. SWCS claimed that "had the Payment been in respect of emoluments, the proper accounting treatment thereof would have been to write the payment off in the year in which it was made". It also claimed the Smith & Williamson Group would have been better off had the Payments were for staff remuneration. Ms Hodge submits that as:

> 1. the proper accounting treatment for the situation where SWCS treated the Payment as being in respect of employment income was not agreed between the parties;
>
> 2. the corporation tax treatment of the acquisition of any intangible asset and the deductibility of the Payment was not before the tribunal; and
>
> 3. SWCS had not adduced expert evidence in support of its contention,
>
> I should attach no weight to Mr Pearce's evidence on the point.

Symmetry

91. Ms Hodge further contends that there was no general proposition that the legislation governing the business taxation of an employer and the personal taxation

of its employees was designed to produce symmetrical treatment. The case of *Macdonald (Inspector of Taxes v Dextra Accessories* [2004] EWCA Civ 22, which appeared to support the proposition, was concerned with one section within the overall statutory framework that might have delayed a tax deduction for the employer if income tax liability was not crystallised for the employee. It was stretching the point too far to extrapolate from that a supposed general proposition of symmetry.

Not Chargeable Gains

92. Finally, Ms Hodge confirms that were I to find the Payment not to be employment income, HMRC did not contend it was taxable as a chargeable gain.

Submissions for SWCS

93. Dealing first with factual matters, Mr Maugham submits that the client connections were the Team's to sell (and not Butterfield's). In part for so claiming he relies on evidence from Mr Pearce to the following effect:

> "… one of the interesting things to me about these acquisitions is that neither Bank of Butterfield nor Barclays [the employer of a separate team acquired by the Group] came to us and said 'We have an asset that you are seeking to acquire. Will you pay us for it?' I would do that if I had an asset that I was seeking to dispose of, which I can only deduce that neither Bank of Butterfield nor Barclays believed that they had an asset to sell."

94. Similarly, as Mr Smiley explained in cross-examination:

> "Well, I mean, it is very difficult to second-guess what is in the mind of a third party institution. With regard to Butterfield, they would have known how close our team were with the client base and how he had built up the business and, actually, in my case and Shane Chichester's case successfully moved the core of the business from Panmure Gordon in 1996. So perhaps they might have thought that they didn't have anything to sell, or relationships to sell".

95. Mr Maugham further submits the evidence to show that SWIM acquired the client connections. For that purpose he relies on Mr Pearce's evidence in cross-examination that clients, once they moved to SWIM, tended, because of the quality of the package offered by SWIM (in contradistinction) to that offered by others, not to move on. As Mr Pearce put the matter in cross-examination:

> "… we would have an asset to sell because we actually look after our clients properly and they are more or less loyal to us. What I said earlier, what Barclays – in my judgment at least, what Barclays and Bank of Butterfield did was effectively to give up their ownership by their actions."

96. In dealing with the question of the relationship between the Payment and remuneration from the Team's employment, Mr Maugham submits the evidence to be inconsistent with the Payment being from the employment. He relies on the fact that two separate and independent contracts were prepared, and that the negotiations

leading to the contracts were conducted separately and at different times. Mr Maugham adds that the sums payable and paid under the two types of contract were calculated at market rates at arm's length. For me to conclude that the Payment was from employment, he contends that I should have to conclude that SWIM decided to pay to the Team money additional to that to which they were entitled under their contracts of employment for services they had already agreed to render under those contracts. Further, the Payment was calculated by reference to the value of client connections, and was apportioned between the members of the Team as Mr Smiley determined in consultation with its other members.

97. Mr Maugham notes that "qualifying funds" for the purpose of calculating the amount of the Payment were only those transferred with the Team, and not those introduced by the Team from other sources. Further, the Payment was made irrespective of whether the Team serviced the funds transferred to SWIM.

98. He suggests that the payment made to Annabel Somers was to buy out her share of client connections. The evidence he relies on for the purpose is: (a) internal Group correspondence; (b) correspondence with Ms Somers herself; and (c) the fact that the remaining members of the Team agreed that it was appropriate to deduct from the payment distributable to them the sum paid to Ms Somers.

99. Accepting that para.5 of Mr Smiley's contract of employment might be the basis on which it could be said that the Payment related to Mr Smiley's employment (see para 45 above), Mr Maugham notes that the reward for attracting new clients under the SWCS contract of employment lay in the deferred share plan explained by Mr Pearce in evidence (see para 46 above).

100. Of a suggestion by Ms Hodge in her cross-examination of Mr Pearce that some importance attached to the fact that it was part of the Team's duties under their contract of employment to service the SWIM's clients. Mr Maugham contends that the Payment was not for servicing the clients; it was either consideration for selling those relationships to SWIM or the service of transferring them to SWIM.

101. Mr Maugham submits that each of those factors set out in para 47 above in relation to question 5, "What do the terms of the 2006 Contract tell one about the source of payment?", taken alone is consistent with the Payment being otherwise than from employment: taken together they are inconsistent with the Payment being from employment.

102. Mr Maugham submits that the transactions into which the Team entered into either were, or were closely analogous to, an "earn-out" (see HMRC Manual ERSM at paras 110920-40 and to the "Frequently Asked Questions on the Taxation of Employment Related Securities Following the Finance Bill 2003"). He maintains that the criteria there identified by HMRC as being relevant are, indeed, relevant and invites me to apply them in the present case. In circumstances where: (i) both SWIM and the Team saw the Payment as purchase consideration for the latter's client connection; (ii) where the Team commenced employment with the Group; and (iii) where the consideration for the client connection was contingent Mr Maugham

submits those criteria to be a useful guide to determining whether the Payment, or any part of it, was "for employment". Addressing each of the criteria in turn, he contends that:

> *a. The sale agreement demonstrated that the earn-out was part of the valuable consideration given for the securities of the old company.*
>
> The Payment was to be made under the terms of the 2006 Contract between SWIM and each of the members of the Team and not under each of their employment contracts with SWCS.
>
> *b. The value received from the earn-out reflected the value of the securities given up.*
>
> The evidence was that there was a market in the disposal of client connections and the price paid was the market price.
>
> *c. Where the vendor continued to be employed in the business, the earn-out was not compensation for the vendor not being fully remunerated for continuing employment with the company.*
>
> The evidence was that the Team received a market rate of payment and Mr Smiley regarded his salary as generous.
>
> *d. Where the vendor continued to be employed, the earn-out was not conditional on future employment, beyond a reasonable requirement to stay to protect the value of the business being sold.*
>
> The evidence was that two years was a reasonable period to procure the transfer to, and bedding in with SWIM, - of the Team's clients.
>
> *e. Where the vendor continued to be employed, there were no personal performance targets incorporated in the earn-out.*
>
> The performance targets all related to the performance of the "book of business" that the Team was to bring across. There were no personal performance targets.
>
> *f. Non-employees or former employees received the earn-out on the same terms as employees remaining.*
>
> That criterion was irrelevant as all of the earn-out recipients transferred.

103. Turning then to the law, Mr Maugham submits that the question of whether the Payment is "from" employment is a short one which is amenable to a short answer.

104. He first notes that, as a general proposition, the legislation governing the taxation of employers and employees is concerned to achieve symmetrical treatment as between the two: an immediate corporation tax deduction should not be available to the former unless an immediate income tax liability is crystallised for the latter:

see, for example, *Dextra* 22. And where an immediate corporation tax deduction was not available to the employer it would be surprising if an immediate income tax liability was crystallised by the employee.

105. Mr Maugham also notes that, were the Payment to be staff remuneration, the Group would be better off. As Mr Pearce explained in evidence, the value to the Group of obtaining an immediate deduction for the Payment exceeded the employer's NICs liability on treating the Payment as remuneration.

"From" employment

106. Ms Hodge sought to suggest in cross-examination of Mr Pearce that some importance attached to the fact that it was part of the Team's duties under their contract of employment to service the clients. Mr Maugham contends that the Payment was not for servicing the clients; it was either consideration for selling those relationships to SWIM or the service of transferring them to SWIM. Turning then to the background to the statutory question, he relies on the following passage from the speech of Lord Templeman in *Shilton v Wilmshurst* [1991] STC 88 (at 91 e-g) :

> "The authorities are … concerned to distinguish in each case between an emolument which is derived 'from being or becoming an employee' on the one hand, and an emolument which is attributable to something else on the other hand, for example, to a desire on the part of the provider of the emolument to relieve distress or to provide assistance to a home buyer. If an emolument is not paid as a reward for past services or as an inducement to enter into employment and provide future services but is paid for some other reason, then the emolument is not received 'from the employment'. The task of determining whether an emolument was paid for being or becoming an employee or was paid for another reason, is frequently difficult and gives rise to fine distinctions."

107. Mr Maugham submits that the present case lies towards the less difficult end of the spectrum saying that the facts were very close to those in *Hose v Warwick* (1946) 27 TC 459 where Mr Hose was departmental manager of his employer and had a number of personal clients. He was offered the job of managing director and, on taking up that job, those clients became clients of his employer. A payment of a lump sum of £30,000 made to him in respect of giving up those relationships to his employer was held not to be from his employment

108. However, even ignoring *Hose v Warwick*, Mr Maugham further submits that from the facts one is inexorably led to the conclusion that the Payment was for the acquisition of client connections rather than being "from" employment for:

(1) SWIM's existing fund managers had capacity to cope with "at least an additional £1.5 billion of funds under management"; what it was looking for was not additional fund managers but funds under management;

(2) from both SWIM's and Mr Smiley's perspectives, the transaction was one of the acquisition of client connections. Moreover, that was how Deloittes advised it should be accounted for under GAAP;

(3) the Payment was made pursuant to a separate contract between Mr Smiley and SWIM and was made by SWIM. It was not made pursuant to Mr Smiley's contract of employment with SWCS;

(4) the Payment was separately negotiated from the sums payable under Mr Smiley's contract of employment;

(5) the quantum of the Payment was contingent on how client connections performed, and not upon any personal performance targets;

(6) the Payment was additional to the salary and bonus payable under Mr Smiley's contract of employment which were on both industry and the Group's standard terms. Indeed Mr Smiley said he saw the salary as "very full market rate of pay" and "a significant improvement in remuneration over the terms of [his] then existing employment";

(7) the Payment was calculated by reference only to funds under management brought over from existing clients by Mr Smiley and the remainder of the Team and not, as Mr Pearce explained, clients or funds under management from "organic" sources which were separately remunerated;

(8) the Payment was payable as soon as a minimum requirement to secure transfer of the relationships and funds under management had expired;

(9) when a member of the Team left early, the Team nevertheless bought out her capital interest recognising that the Payment was not for her service as an employee. And the pool available to the other members suffered a corresponding reduction;

(10) the Payment was made to the Team and, as Mr Smiley explained, the Team decided the proportions in which its members received it. The Team also retained a residual right to alter the proportions in which the Payment would be received; and

(11) the Payment was made in respect of funds under management brought over by the Team, whether or not the Team serviced them. The Team brought in sixteen separate funds and did not service them, but Mr Pearce said that nevertheless Payment was made in respect of those funds.

109. To such extent as it is relevant, Mr Maugham contends that SWIM's strategy succeeded for:

(1) Once clients moved to SWIM with the Team they "stuck" there even when Team members moved on;

(2) SWIM's funds under management increased from £5.4bn in 2004 to £12.1bn in 2012 and operating margins in the investment division improved from 17% in 2004 to 26% in 2011;

(3) The rate of conversion of previous clients of the Team was in line with the Group's hopes and expectations. By April 2008, some 494 clients had moved with the Team;

(4) Of the £380 -£400 million under management by the Team before the move to SWCS, some £320 million had transferred to SWIM by June 2008 of which the vast majority remained with SWIM to date; and

(5) SWIM believed it had recovered the cost of acquiring the Team's relationships by May 2010.

Submissions for Mr Smiley

110. Although the submissions of Mr Rivett overlap those of Mr Maugham, and he invites me to reach the same conclusion as Mr Maugham, I consider it appropriate to include them as his emphasis in part differs from that of Mr Maugham. Mr Rivett initially advances five legal propositions for Mr Smiley:

a) Not every sum paid by an employer to an employee is a sum paid 'from employment' for the purposes of the income tax code, see e.g. *Kuehne & Nagel* at para 50.

b) The question is always 'was this sum paid from employment?' He submits that the answer will be 'no' if it is paid for something else.

c) In ascertaining what a sum is paid for, you look at the contracts in the light of the surrounding circumstances. Whilst there is no necessary symmetry between the tax treatment of a payment from the perspective of the payer and the tax treatment of the payment in the hands of the recipient, the nature of a receipt in the hands of an employee will in part turn on the purpose of the employer in making the payment.

d) 'Personal connections', 'customer connections', and 'goodwill' (howsoever described) are an 'asset' as a matter of general principle, see *Hose v Warwick* at p.473. Such 'connections' are also capable of constituting an 'asset' for the purposes of the capital gains tax code, see *Kirby v Thorn EMI* 60 TC 519 at pp.541-542**)**

e) An asset such as a 'personal connection' or 'customer connection' can belong to an employee, and not his employer, notwithstanding the fact of the employee's employment and the employer's ownership of the business through which the connections are exploited, see the facts of *Hose v Wariwck* at p.468. If an employee disposes of such an 'asset' to his employer, that sum will constitute a capital receipt which is not from his employment An employee can part with such a 'personal connection' either through an assignment or by providing a covenant not to solicit and deal with the connection in question.

111. Mr Rivett submits that the Payment by SWIM was made to acquire client connections, relying for the purpose on a number of factors, namely:

a) The Payment was made pursuant to the 2006 Contract. As a matter of construction the terms thereof made plain that the Payment was made for the acquisition of client connections. The terms of the contract were corroborated by the witnesses, each one stating that the Payment was made for an asset, namely the 'goodwill' or the 'book of business', as it was described by Mr Smiley. Further, it was plain that the 2006 Contract was entered into by SWIM pursuant to its strategy of expanding the amount of funds under its management.

b) The terms of the 2006 Contract and surrounding circumstances made plain that SWIM was acquiring client connections from the Team in consideration of a fee, and not for services per se. That contract contained a formula for determination of the Payment – a formula that related to the amount of funds under management by SWIM at the end of the goodwill period derived from a client of the Team prior its joining the Group, less certain expenses including the salaries and incidental costs of the Team. The Payment was payable to the Team as a whole, and it was for the Team to apportion the Payment between different members of the Team. Although an individual member of the Team would lose his entitlement to part of the Payment should he or she cease to be employed by the Group prior to 30 April 2008, his or her share would be split between the remaining members of the Team. Were an individual to leave, the amount to be shared among the remaining members of the Team would increase since there would be no need to include his or her salary in the 'expenses' to be deducted from the Payment. Although the 2006 Contract provided that a member of the Team who left the Group's employment before 30 April 2008 would not be entitled to a share in the Payment, notwithstanding that the Payment was not due to be made until 30 June 2008, a member who left in May or June of that year would nevertheless be entitled to his or her share of the Payment. The Group did not require the fund management services of the Team in order to service any funds acquired under the 2006 Contract, having facilities to service at least an additional £1.5 billion through its existing workforce. The Payment was made in respect of funds which were not in practice managed by members of the Team.

c) SWIM considered that, in entering into the 2006 Contract, it had acquired an intangible asset, and accounted for it on that basis in its audited accounts.

d) Mr Smiley received generous remuneration for his services as an employee of the Group, being entitled to a salary, discretionary bonus and a pension. In evidence, Mr Smiley referred to his salary as being a 'very full rate of pay', and a 'significant improvement in my remuneration over the terms of my then existing employment'.

112. Mr Rivett further submits that 'client connections', 'personal connections' and 'goodwill', however labelled, are as a matter of principle an 'asset'; they are also capable of constituting 'assets' for capital gains tax purposes. In those circumstances, he contends that the connections in point in the present appeal were an asset in the

hands of Mr Smiley and the other members of the Team. Mr Rivett bases his contention on a number of facts and matters.

113. He observes that the label 'goodwill' attached by the parties in the negotiations leading to the Payment was merely a convenient layman's description of client connections; it was not apt in a legal sense to describe the nature of the client connections. But that did not mean that no proprietary rights were capable of existing in them, nor did it mean that SWIM did not acquire an asset. The right to exploit the personal client relationships built up by the Team was an asset distinct from any 'goodwill' inherent in the brand of any former employer of the Team; that was evident from the fact that those relationships were transferred from Leopold Joseph & Sons Ltd, to Butterfield and to SWIM.

114. Mr Rivett maintains the following facts to be relevant to the fact that the Payment was made for the disposal/acquisition of an asset:

a) It was the unchallenged evidence of Mr Smiley that the Team had built up valuable connections at the time of the sale, and that the 'book of business' he described was, as a matter of principle, an 'asset', and those connections were capable of constituting an asset for capital gains tax purposes.

b) Both the unchallenged evidence of Mr Pearce and Deloittes demonstrated that SWIM had acquired a capital asset under the 2006 Contract. Intuitively, that asset must have been acquired from somewhere; in the instant case, the evidence overwhelmingly demonstrated that it was acquired from the Team.

c) The Group put in place measures to ensure that, once acquired, client connections was retained. The measures required Mr Smiley and key members of the Team to enter into covenants restricting their employment in practice for 12 months following termination of their employment with the Group; that contrasted with the Leopold Joseph and Butterfield restrictions which in Mr Smiley's case lasted only 6 months and, in the case of other members of the Team, were either minimal or non-existent

d) Client connections was adhesive and remained under management with SWIM notwithstanding (1) certain of the funds transferred were not managed by the Team, and (2) the departure from the Group of members of the Team.

115. Of a claim by HMRC that, if the Payment was not made for an asset, it fell to be taxed under Schedule D Case VI, Mr Rivett maintains that that could not be the case; Mr Smiley accepted that if the Payment was not made for the disposal/acquisition of an asset, it must inevitably constitute employment income for the purposes of s.9(2) ITEPA. Contrary to the submissions of Mr Maugham, Mr Rivett maintains that the mere fact that the Payment was made under the 2006 Contract did not mean that the Payment could not be employment income. There was no contractual entitlement in the cases of *Laidler v Perry* TC 42 352 and *Shilton*, yet in the latter case, where the payment in question was made by the taxpayer's former employer, the House of Lords, found the sum paid to be an emolument of his new employment. In Mr Rivett's

submission the fact that the Payment was made under the 2006 Contract was simply one piece of evidence suggesting that the sum was paid for something other than the employment; it was not determinative of the issue. Nor, again contrary to the submission of Mr Maugham, was the fact that the terms of Mr Smiley's contract of employment contained provision for a market rate of remuneration mean that the Payment could not, as a matter of principle, constitute employment income. Again the provision constituted one piece of evidence that the Payment was made for something other than the employment; it was not determinative. Further if the Payment was made for the acquisition of services, it was difficult to see how those services could not be said to be part of Mr Smiley's contract of employment. It was plain from the terms of the contract itself that Mr Smiley was obliged to further the client business of the Group; and both Mr Smiley and Mr Pearce made plain that part of the former's job was to bring in work.

Discussion and conclusion

116. As I indicated earlier in my decision (see paras 30 and 31), the answer to the first two questions of fact posed by Mr Maugham (see para 27) are plain: the Group's strategy in relation to the recruitment of the Team and the acquisition of the client connections was to seek to increase private clients' funds under management mainly through a series of acquisitions of business units; and it perceived the Payment to have been made for an asset.

117. I then turn to Mr Maugham's third question, "Did the Team have an asset to sell?" In order to answer that question there are certain preliminary findings I must make. I first find that the Team was able to, and did, introduce its clients to SWIM. I have no hesitation in also finding that some investment clients who were originally clients of Panmure Gordon and/or Leopold Joseph & Sons Ltd and/or Butterfield followed the Team to SWIM.

118. I accept Mr Rivett's submission that 'client connections', or to use Mr Smiley's expression 'book of business', whichever label is employed, as a matter of principle can be an asset; and that the client connections as transferred to SWIM were an asset in the hands of Mr Smiley and the other members of the Team. In my judgment the client connections clearly fall within the capital gains tax definition of an asset (see para 53 above)

119. In dealing with the third question I have taken into account the submissions of Ms Hodge at para 66 that the Payment was from employment, not the disposal of a capital asset, and would make the following observations thereon. I accept that the 2006 Contract made no mention of the sale of anything by Mr Smiley to SWIM, and that the Team did not own the client relationships forming the client connections either individually or collectively. I further accept that SWIM acquired the client connections as a result of its employing the Team.

120. I do not consider it appropriate further to deal with question 3 at this stage of my decision, and will return to it a little later. My answer must follow a consideration of the relevant case law.

121. Next, I propose to consider Mr Maugham's fourth question: "What was the relationship between the Payment and remuneration from the Team's employment?" (see para 44). I shall deal with that matter in the same order as did Mr Maugham. He claims the evidence to show the Payment to be inconsistent with being from the Team's employment. I accept that the negotiations for Mr Smiley's and the other members of the Team's contracts of employment and those for the 2006 Contract were separate and distinct; the negotiations leading to the two were conducted independently, and over different time frames. The evidence adduced as to the similarity of the level of the sums payable under the Team's contracts of employment and those payable to existing members of SWIM's staff of similar stature and experience to Mr Smiley and the Team went unchallenged, so that again I accept it. Further, I find that the sums payable under the contracts of employment were market rate sums having been negotiated by the parties thereto at arm's length and on arm's length terms. As Mr Pearce claimed in evidence, the Payment was calculated by reference to the client connections delivered by the Team as a whole, and was apportioned among its members as determined by Mr Smiley in consultation with them. The 2006 Contract did provide that "qualifying funds" for the purpose of calculating the amount of the Payment were only those transferred with and by the Team. Additionally the Payment was made irrespective of whether the Team serviced the client funds under management transferred to SWIM by the Team. Those matters I regard as suggesting that the Payment was for the client connections, and did not arise from the employment of the Team.

122. In contrast, Ms Hodge submits that the formula for calculating the amount of the Payment was clearly structured to encourage the Team to bring new business to SWIM, was part of the performance of the duties of their employment, and depended on the retention of that new business; and that the Payment was made as reward for the Team's services under their contracts of employment. I am unable to accept those submissions. I do however accept, as does Mr Maugham, that clause 5 of Mr Smiley's contract of employment, in requiring him inter alia to use his "best endeavours to maintain, develop and extend the business of SWCS and the group", might also suggest that the Payment related to his employment, and thus was from his employment. In my judgment, the method of payment of the Payment was structured to ensure that the Team found it in their own interests to remain in SWIM's employment, and was calculated by reference to such part of the client connections as SWIM retained at the end of the goodwill period. And since the Team did not continue to manage at least some of the sums transferred, I am unable to agree with Ms Hodge that the introduction of new business by the Team under their contracts of employment played any part in either the structuring or the calculation of the Payment. The Team's reward for introducing new business consisted in the benefits to which they became entitled under the deferred share plan and/or to bonuses for which their contracts of employment made provision.

123. I accept the claims of both Mr Maugham and Mr Rivett that, since the 2006 Contract was negotiated and made some time after the Team entered into their contracts of employment, it at least points to the Payment being inconsistent with its having arisen from the employment of the Team by SWIM.

124. I do not regard the arrangements made to pay Annabel Somers on her leaving the Group's employment as assisting one way or the other in determining whether the Payment was from the Team's employment. The payment to her was essentially made under the compromise agreement she entered into. That her payment reduced the amount to which the remainder of the Team became entitled, I accept, but I do not regard that as helpful in indicating whether the Payment was from their employment.

125. I am unable to accept Ms Hodge's submission that the Payment reflected the extra income/profits generated by reference to the Team's business contacts. As mentioned at para 122 above, in my judgment, the Team's contracts of employment provided for them to be rewarded for new business they introduced to SWIM by way of share options and bonuses; the Payment was said to be made under the 2006 Contract for the acquisition by SWIM of the client connections. In my further judgment, the 2006 Contract was not an adjunct to the Team's employment contracts.

126. Again it is inappropriate for me to provide a firm answer to question four until I have considered the relevant case law. My answer must therefore await that consideration.

127. It will be recalled that, in relation to the points he made in dealing with his fifth question, "What do the terms of the 2006 Contract tell one about the source of the Payment?", Mr Maugham submits that each point taken individually is sufficient to enable me to find that the Payment was not from the Team's employment. Much more realistically, in my judgment, Mr Rivett contends that the points taken individually form one piece of evidence that the Payment was made for something other than from the employment; they are not individually determinative.

128. I accept the facts that the 2006 Contract was made by members of the Team with SWIM rather than SWCS, and that the Payment was made under the 2006 Contract, suggest that the Payment was not made from the employment. So too do the facts that the Payment was made to the Team, it was for its members to decide how the Payment should be shared among them, and that the Payment was calculated by reference to the funds under SWIM's management at the end of the goodwill period.

129. I find that the Payment was not made for the management by the Team of the funds acquired by SWIM. In my judgment, the evidence points to their having received their reward for managing the funds well under their contracts of employment.

130. It is the fact that the Payment was a one-off and calculated by reference to funds under management by SWIM on a particular date. That suggests to me that it was not made from the employment.

131. If a Team member were to leave before the end of the goodwill period, that would or could reduce the expenses element of the Payment. It is also the fact that if a Team member left SWCS before the end of the goodwill period his or her share would be distributed amongst the remaining members of the Team. Consequently, the Payment involved a contingency which had nothing to do with the employment status

of the recipient. I accept that that was inconsistent with the Payment being from the employment of the Team. I further accept that if a Team member left before the end of the goodwill period, his or her share of the Payment would be distributed amongst the remaining members of the Team – another contingency that had nothing to do with the employment status of the recipient.

132. Of a submission by Ms Hodge that the Payment arose from the employment of the Team, rather than from the disposal of a capital asset, I observe that she places considerable reliance therefor on the facts that the 2006 Contract made no mention of the sale of anything, and that the Team did not own the client connections and thus had nothing to sell. Whilst accepting the basis of the submission, I do not accept the submission itself; it runs completely contrary to the evidence adduced by the two appellants as to that matter, evidence I accept without reservation.

133. Ms Hodge also claims that SWIM's desire to obtain the client connections, rather than wanting to engage the Team itself, does not support the appellants' contention that the Payment was for the acquisition of an asset rather than being from the employment. I do not agree. The fact is that the Group did employ the Team, and the terms of their employment were comprehensively set out in their individual contracts of employment.

134. It will be recalled that Ms Hodge accepts that the Payment had been correctly capitalised in SWIM's accounts, but submits that the tax treatment of the Payment in the hands of the Team does not necessarily follow that treatment. She particularly observes that the acquisition of a team at Birmingham on terms similar to those of the Team resulted in the Birmingham team having their payment for client connections taxed as income from their employment. I note her observation, but since HMRC's view in that behalf has not been tested before the tribunal, regard it as taking things no further.

135. Once more, my answer to the question must await my consideration of the relevant case law.

136. In relation to Mr Maugham's question six, "What happens if HMRC's earn-out criteria are applied to the present facts?" I accept all his contentions as being key indicators that the Payment was consideration for the client connections rather than remuneration.

137. "Did the Group's strategy succeed?", Mr Maugham's seventh and final question, I can only answer in the affirmative. That answer also suggests that the Payment was of a capital rather than an income nature, and thus was not from the Team's employment

138. I do not regard the fact that SWIM treated as an intangible asset the sum of £3,752,595, i.e. the total to which the Team was entitled less £57,400 paid to Annabel Somers, as assisting in determining whether the Payment was from the Team's employment.

139. Although I was referred to quite a number of cases by the parties, in reaching my conclusion I propose to focus my attention on but a few of them. Since the *Shilton* case is a decision of the House of Lords, and I am bound by it, I must necessarily pay it close attention. The same applies to *Hochstrasser v Mayes* and *Laidler v Perry*, the decisions in them being relied on by Lord Templeman in *Shilton* itself. The *Kuehne & Nagel* case is a recent decision of the Court of Appeal; and the case of *Hose v Warwick* is, in my judgment, the closest factually to the present case.

140. I should perhaps also mention that I was referred to a recent First-tier Tribunal case, that of *Manduca v HMRC* [2013] UKFTT 234 (TC). There a sum was payable for four separate matters: the personal services of the taxpayer and his partner as individuals; the customer relationship owned by the taxpayer and his partner; the sale of a hedge fund vehicle model; and the right to charge fees to a book of clients. The tribunal held the payment in that case to arise from the employment. In his closing submissions, Mr Rivett contends that I should consider that decision both unreliable and distinguishable from the present case; the facts were completely different, and the reasoning of the tribunal was wrong and/or unreliable. He observes that, in *Manduca*, the question of whether the sums in question were employment income was not raised, nor was the tribunal apparently taken to the case of *Kuehne v Nagel.* Further, where the tribunal considered *Hose v Warwick*, it distinguished that case on the "errant basis" that the reasoning of the court turned on the fact that the sale of the asset by Mr Hose occurred after the time he had been employed by the firm for some time, and not at the time he first joined it. As the decision in the *Manduca* case is merely persuasive, and counsel other than Mr Rivett did not make any detailed submissions on it, I do not propose to place any reliance on it.

141. The test to be applied in determining whether a payment is taxable as being from employment was set out by Lord Templeman in the *Shilton* case at 105f in the following way:

> "[Employment income] is not confined to 'emoluments from the employer' but embraces all 'emoluments from employment'; the section [s.6 ITEPA] must therefore apply first to an emolument which is paid as a reward for past services and as an inducement to continue to perform services and, secondly, to an emolument which is paid as an inducement to enter into a contract of employment and to perform services in the future. The result is that an emolument 'from employment' means an emolument 'from being or becoming an employee'."

142. Consequently, I as the tribunal must look for the reason for the payment; the question is one of causation. This emerges from the words of the statute by stating that the earnings or income must come "from" the office or employment. It is plain that for the second limb – that relevant in the present case – to apply, it is not enough that an emolument is paid as an inducement to enter into a contract of employment; it must also be paid as an inducement to perform services in the future.

143. I observe in passing that in the *Shilton* case the House of Lords was concerned with a "signing-on fee" paid to the taxpayer, the entirety of which was conceded by him to be an emolument despite his arguing that it was not "from" his employment. In contrast, in the present case, SWCS and Mr Smiley deny that the Payment, or at least that part of it Mr Smiley received, was an emolument of his employment.

144. In the *Shilton* case, HMRC argued that the test in terms of reward for services emerging from *Hochstrasser v Mayes* was no longer sufficient – an argument that apparently was unsuccessful. In the latter case, where the question before the court was whether a loss covered by the taxpayer's employer under an employee loan scheme was an emolument from his employment, Lord Radcliffe said at 391:

> "The test to be applied is the same for all. It is contained in the statutory requirement that the payment, if it is to be the subject of assessment, must arise 'from' the office or employment… [Glosses on the statutory words] are all of value as illustrating the idea which is expressed by the words of the statute. But it is perhaps worth observing that they do not displace those words. 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."

145. Lord Radcliffe said that an emolument paid to an existing employee was "assessable if it ha[d] been paid to him in return for his agreement to act as or become an employee". He decided that the emolument had not been paid to the employee in return for his acting as or being an employee, saying at 392:

> "The essential point is that what was paid to him was paid to him in respect of his personal situation as a house-owner, who had taken advantage of the housing scheme and had obtained a claim to indemnity accordingly. In my opinion, such a payment is no more taxable as a profit from his employment than would be a payment out of a provident or distress fund set up by an employer for the benefit of employees whose personal circumstances might justify assistance."

146. In the *Shilton* case, having cited Lord Radcliffe's observations in *Hochstrasser v Mayes* set out above, Lord Templeman noted that part of Mr Shilton's signing-on fee was paid by his new employer as an emolument for agreeing to act as or become its employee and for no other reason, and the remainder was paid by his former employer for the same reason. In those circumstances, Lord Templeman said, "The taxation consequences to Mr Shilton should be and are the same."

147. Lord Templeman went on to consider the case of *Laidler v Perry*, where a company gave each of its employees a gift voucher of £10 each Christmas. He cited the following passage from the speech of Lord Reid at p.30:

> "There is a wealth of authority on this matter and various glosses on or paraphrases of the words in the Act appear in judicial opinions, including speeches in this House. No doubt they were helpful in the circumstances of the cases in which they were used, but in the end we must always return to the words in the statute and answer the question – did this profit arise from the employment? The answer will be 'no' if it arose from something else."

148. Having noted that Lord Reid agreed with HMRC's finding that the vouchers were made available for services rather than as gifts not constituting a gift for services, and thus were taxable as being from employment, Lord Templeman held that in the *Shilton* case both sums paid "were made available in return for Mr Shilton's agreement to render services".

149. In the *Kuehne & Nagel* case, it was held by the Court of Appeal that the FTT correctly considered the circumstances of, and the reasons for, payments made to employees on the occasion of the transfer of their employment from one company to another, and concluded that they were liable to income tax and NICs as emoluments. At para 50 Patten LJ said:

> "What constitutes an emolument or other benefit from an employment has been the subject of judicial analysis for almost 100 years. As Mummery LJ has explained in his judgment, our task is to apply the statutory test to the facts found and not to apply some other test based on a gloss: see e.g. *Hochstrasser v Mayes* per Lord Radcliffe at p.707. But some gloss is inevitable because it is accepted that it is not enough merely to show that the payment was received as an employee and would not have been received if the individual had not been an employee. Something more must be established. This has been expressed in terms of the difference between *causa sine qua* non and *causa causans* but it does, on any view, require a sufficient causal link to be established between the payment and the employment."

150. I need not repeat the passages from the judgment of Mummery LJ in *Kuehne v Nagel* relied upon by Ms Hodge; they are to be found at paras 72 and 73 above. I should record that I have considered them.

151. In my judgment, the *Kuehne & Nagel* case takes things no further than did that of *Shilton.*

152. As I mentioned earlier, in my judgment the facts of the case of *Hose v Warwick* are closest to the facts in the present case, and I propose to follow it. I therefore propose to consider it in some detail. There Mr Hose was departmental manager of his insurance broker employer, and had a number of personal clients. He was offered, and accepted, the job of managing director of his employer, and on taking up that position his personal clients became those of his employer. The employer paid him £30,000 for giving up his personal relationships.

153. Atkinson J observed at 472 that "There are two ways in which you can part with a connection. You can assign it, or you can covenant not to solicit and deal with the customers. That is the method which, in fact, was adopted…I have referred to the…covenants restraining him completely from competing in any way if his agreement is terminated".

154. In holding that the payment was not from Mr Hose's employment, the judge said:

> "To my mind it is perfectly clear that the £30,000 had nothing whatever to do with his remuneration as managing director…[I]t was a sum paid to him for abandoning to the company his personal connections, and securing their hold on it by the covenants in clauses 19 and 20".

155. Atkinson J continued:

> "It seems to me impossible to say in truth and in fact that it was paid in respect of services as managing director, in face of the acceptance of the evidence of Mr Parsons [Mr Hose's accountant] and Mr Hose as to the mutual understanding that it was paid for his connection, and in face of the circular to the shareholders in which the board described this change as one which was handing over to the company Mr Hose's connection. I can see no difficulty in construing the document once one knows what the position was and what his rights under the agreement were, and once one appropriates how his personal connection had been preserved to him by those rights, and how under this agreement that connection…was secured to the company…"

156. Atkinson J considered the case of *Duff v Barlow* 23 TC 633 as "the nearest case to this". There it was agreed that "a rather vague arrangement" between the taxpayer, Mr Barlow, and his employer, under which certain unascertained commissions payable to him proved to be much higher than the parties expected, should be terminated in the employer's interests in consideration of a payment to Mr Barlow of £4,000 for the loss of his rights to future remuneration under the earlier agreement. Lawrence J, the judge in the *Barlow* case, held that what in truth was being paid was compensation for loss of office which was a source of income, and was a capital payment. Atkinson J concluded his judgment in the *Hose* case saying:

> "[The *Barlow* case] seems to me to be very like this case, except that this case is stronger. Mr Hose lost an office which brought him up to £10,000 a year. He also in fact made over to the company a valuable connection which was a capital asset. I can see no conceivable reason for not giving effect to what everybody must have known was the plain intention of the parties, and I think this appeal must be allowed."

157. I return then to Mr Maugham's third question, " Did the Team have an asset to sell?" Since the Team did not own the client connections, it could not have sold them. Thus my answer to the question is "No". What it was capable of doing, and in my judgment did, was to transfer to SWIM the right to exploit its client connections with

the clients of Butterfield; and SWIM paid for and received, or came into possession of, those relationships, but no more. As Mr Rivett submits, as a matter of construction the 2006 Contract made plain that the Payment was made for the acquisition of the client connections. I regard it as self-evident from the steps taken by SWIM to protect its investment (see para 42) that it did not regard itself as owning the client connections transferred to it.

158. I earlier dealt at some length with the submissions of Mr Maugham as to his fourth question, that of the relationship between the Payment and remuneration from the employment. I indicated that his submissions suggested that the Payment was for the client connections, and that I was unable to accept the submissions of Ms Hodge on the point. Having further considered Mr Maugham's submissions in the light of the case law to which I have referred, I conclude that the Payment was inconsistent with its being from the Team's employment.

159. To sum up, Mr Smiley's contract of employment and the 2006 Contract were two separate and independent contracts, the former being made some time before the latter. The negotiations for his contract of employment and those for the Payment were conducted independently. The sums payable under the contract of employment and the 2006 Contract were market rate sums calculated by the parties thereto at arm's length and on arm's length terms, and it follows, and I infer, that the sums payable under the former represented full payment to Mr Smiley for the services he had agreed to and would in future provide to SWIM. The Payment was calculated by reference to the client connections and nothing else; and the qualifying funds were only those transferred with the Team. Further, the 2006 Contract was made with SWIM, and not the employer SWCS; the levels of the payments due under the contracts of employment were similar to those of existing employees of the Group; and the Team's rewards for introducing new business to SWIM were to be found in their entirety in the contracts of employment in the form of pensions, share options and bonuses. Taking those matters in combination I regard them as firmly establishing that the effect of the 2006 Contract was that Mr Smiley and the Team made over to SWIM a capital asset and that the Payment represented full payment therefor. That, in my judgment, was the intention of the parties to the two contracts, and I see no reason to conclude otherwise.

160. In my judgment, my answer to each and every one of the questions posed by Mr Maugham indicates that the Payment was made for the client connections. It follows that, since it was not from the Team's employment, I hold the Payment to have been a capital receipt in the hands of the Team in general, and Mr Smiley in particular, and not a payment from his employment liable to income tax.

161. I allow SWCS's appeals against both the reg.80 determinations and the notices of decision under s.8 of the Social Security Contributions (Transfer of Functions) Act 1999. I also allow Mr Smiley's appeal against the two closure notices.

162. 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.

DAVID DEMACK

TRIBUNAL JUDGE
RELEASE DATE: 22 November 2013