**Hilary Term**
**[2022] UKSC 9**
*On appeal from: [2020] EWCA Civ 663*

# JUDGMENT

## Commissioners for Her Majesty's Revenue and Customs (Appellant) *v* NCL Investments Ltd and another (Respondents)

before

**Lord Reed, President**
**Lord Briggs**
**Lord Sales**
**Lord Hamblen**
**Lady Rose**

**JUDGMENT GIVEN ON**
**23 March 2022**

**Heard on 25 and 26 January 2022**

*Appellant*
Julian Ghosh QC
Jonathan Bremner QC
Charles Bradley
(Instructed by HMRC Solicitors' Office and Legal Services)

*Respondents*
Jolyon Maugham QC
(Instructed by Smith and Williamson)

**LORD HAMBLEN AND LADY ROSE (with whom Lord Reed, Lord Briggs and Lord Sales agree):**

## Introduction

1. This appeal concerns the proper treatment, for corporation tax purposes, of accounting debits ("the Debits") which arose in the accounts of the Respondent Companies (respectively, NCL Investments Ltd, "NCL", and Smith & Williamson Corporate Services Ltd, "SWCS", each a "Company" and together "the Companies"), as a result of the grant to the Companies' employees of options ("the Options") to acquire shares in the ultimate holding company, Smith & Williamson Holdings Limited ("SWHL"), of the Companies' group in the accounting periods to 30 April 2010, 2011, 2012. The grants were made by the trustees of an employee benefit trust ("EBT") of which SWHL was the settlor.

2. The Companies were required by International Financial Reporting Standard 2 ("IFRS2") to recognise in their profit and loss accounts that the services of their employees, who were remunerated in part by the Options, had been consumed in generating their profits. The question that arises in this appeal is whether the consequential Debits are to be taken into account in calculating the profits of the Companies' trades for corporation tax purposes in accordance with the Corporation Tax Act 2009 ("the CTA 2009").

## The Facts

### *(a) The Companies' business and the employee options schemes*

3. The following account of the facts is taken largely from the judgment of the First-tier Tribunal (Judge Jonathan Richards): [2017] UKFTT 495 (TC); [2018] SFTD 92. That judgment is exemplary in the clarity and cogency of its reasoning and we have found it very helpful in understanding the arguments put forward by the parties and the proper construction of the relevant statutory provisions.

4. The Companies employ staff and make those staff available to other companies in the group in return for a fee. That fee is based on the costs that the Companies incur in employing the staff, marked up with a profit element. It is common ground that the activities that the Companies perform in order to earn that fee constitute a trade for corporation tax purposes. The group operates a number of employee share schemes to encourage the employees to hold shares in SWHL. To this end, SWHL set up the EBT with a trustee incorporated in Jersey ("the EBT Trustee"). SWHL makes payments to the EBT Trustee from time to time and the EBT Trustee uses those sums to buy or subscribe for shares in SWHL. The EBT Trustee has the power under the trust deed to grant options over shares in SWHL pursuant to the rules of any share scheme established by any member of the corporate group.

5. From time to time, SWHL establishes a share scheme setting out a framework for the grant of share options to employees. The framework covers matters such as which employees are eligible to be granted options. When a decision is taken to grant a share option to a particular employee, that option is granted by the EBT Trustee. An employee's contractual rights in relation to that option are therefore rights against the EBT Trustee rather than against SWHL or any other member of the group. The Options that the EBT Trustee grants entitle the holder to acquire a certain number of "A" ordinary shares in SWHL for a specified "exercise price". Typically, there will also be vesting conditions associated with the grant of the Option so that the employee will only be entitled to exercise the Option if, for example, he or she remains employed by the group for a certain period of time or if certain performance conditions are satisfied. The FTT found that senior management within the group regarded the Options as forming part of the remuneration package available to employees and as "serving the desirable commercial objective of incentivising employees of the Group who were employed by the [Companies]": para 15. It was noted that there was no suggestion that the Options were awarded for any ulterior or non-business purpose, nor was there any suggestion that the grant of the Options formed part of any tax avoidance or tax mitigation scheme.

6. The EBT Trustee acquired shares in SWHL so that it would be able to satisfy its obligations if Options were exercised. However, the FTT recorded that there was no strict correlation in terms of timing or number of shares between the volume of shares acquired by the EBT Trustee and the scale of its potential obligations under the Options. The evidence suggested that the EBT Trustee did not at all times hold sufficient shares to satisfy all the Options it had granted. But the EBT Trustee ensured that whenever a particular option was exercised, it would hold sufficient shares to satisfy its obligations under that option.

7. Whenever the EBT Trustee granted Options to the employees of the Companies, the Companies agreed to pay SWHL an amount equal to the fair value of the Options granted to their respective employees. That obligation was reflected in an inter-company balance owed by the Companies to SWHL. Each month, the Companies would settle the inter-company balance due. This arrangement has been referred to in the proceedings as the “Recharge”. The Companies passed the cost of the Recharge on to the other group companies with a mark-up by including it in the fee. The FTT found that the Companies’ object in paying the Recharge would have been to benefit their trade by paying SWHL for the grant of the Options to incentivise the Companies’ employees.

8. Significant numbers of Options granted to employees were never exercised either because the conditions entitling the employee to exercise them were not satisfied or because the Options were out of the money when they matured, that is, because the market value of SWHL shares was lower than the exercise price set in the Option. In the year ended 30 April 2010, for example, over 1.1m Options lapsed without being exercised.

*(b) The accounting treatment of the Options*

9. The accounting years relevant to this appeal are the years ended 30 April 2010, 2011 and 2012. The Companies prepared accounts under the International Financial Reporting Standards promulgated by the International Accounting Standards Board. For the year ended 30 April 2010, the applicable accounting standard was IFRS2 “Share-based Payment” as supplemented by IFRIC8 “Scope of IFRS2” and IFRIC11 “Group and Treasury Share Transactions”. For the years ended 30 April 2011 and 30 April 2012, an amended version of IFRS2 had effect, incorporating the provisions of IFRIC8 and IFRIC11 which were then withdrawn. It was common ground that the group’s accounts complied with all applicable accounting standards.

10. The introductory paras of IFRS2 note that a main feature of the standard is that it requires an entity to recognise share-based payment transactions in its financial statements. The Introduction also describes the purpose of the disclosure requirements included in the standard. They are to enable users of financial statements to understand:

(i) the nature and extent of share-based payment arrangements that existed during the period;

(ii) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined; and

(iii) the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

11. Para 7 of IFRS2 is headed "Recognition" and states:

> "7 An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction.
>
> 8 When the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses.
>
> 9 Typically, an expense arises from the consumption of goods or services. For example, services are typically consumed immediately, in which case an expense is recognised as the counterparty renders service."

12. As the FTT found, it follows from this that any grant of Options by the EBT Trustee to the Companies' employees triggered an obligation on the Companies to recognise an expense in their income statements equal to the fair value of the Options that the EBT Trustee had granted. This amount would not necessarily be recognised immediately but could be spread over a number of accounting periods. The obligation to recognise the expense arose whether or not the Companies had to pay any amount, such as the Recharge, to SWHL or the EBT Trustee, in relation to the grant of the Options.

13. The FTT noted that the required accounting treatment as set out in IFRS2 had caused some controversy at the time when IFRS2 was being proposed because some within the profession thought that the grant of share options to employees did not

involve the incurring of any expense. As set out in IFRS2 Basis of Conclusions, this controversy was recognised and resolved as follows:

> "'**There is no cost to the entity, therefore there is no expense**'
>
> BC40 Some argue that because share-based payments do not require the entity to sacrifice cash or other assets, there is no cost to the entity, and therefore no expense should be recognised.
>
> BC41 The Board regards this argument as unsound, because it overlooks that:
>
> > a) Every time an entity receives resources as consideration for the issue of equity instruments, there is no outflow of cash or other assets, and on every other occasion the resources received as consideration for the issue of equity instruments are recognised in the financial statements; and
> >
> > b) The expense arises from the consumption of those resources, not from an outflow of assets."

14. The FTT found in para 24 that, when applied to this case, this is a recognition that:

> "… when the EBT Trustee granted share options to employees, the Appellants were not required to 'sacrifice cash or other assets' but that nevertheless the Appellants should be obliged to record an expense relating to their consumption of employees' services as part of the share-based payment transaction that involved the options being granted. The rationale for that treatment is that the expense in question is not the sacrifice of cash or other assets, but rather the consumption of services that the employees provided to the Appellants."

15. As to the value of the expense that was required to be recognised, paras 10-12 of IFRS2 provide that the entity is required to measure the goods or services received and the corresponding increase in equity either directly if that is possible, or indirectly by reference to the fair value of the equity instruments granted. For transactions with employees, the entity is required to measure the fair value of the equity instruments granted, because it is typically not possible to estimate reliably the fair value of employee services received - in other words since it is impossible to value how much of the employees' services are to be treated as the result of the incentivisation arising from the grant of the Options, the value of those services is assumed to be the same as the fair value of the Options, computed in accordance with the standard. There are further provisions in IFRS2 stipulating how the fair value of options which, like the SWHL Options, are not listed, should be computed and how much of the expense can be allocated to different accounting periods. It was common ground that the Appellants had, in determining the fair value of the Options granted, used an appropriate option pricing model and had allocated that value correctly across accounting periods.

16. If the Options vested but were not exercised, for example because the value of the shares was less than the exercise price, the Companies were not required by applicable accounting practice to make any adjustment to their accounts. As the FTT noted (para 29):

> "… Whether or not employees chose to exercise their options, they had still been given those options and the rationale behind IFRS2 was that the Appellants were consuming the services of employees as part of the transaction that resulted in the options being awarded, whether or not those options were actually exercised."

17. Given that the grant of the Options required the Companies to recognise the Debits in their income statements, the principles of double-entry accounting meant that the Debit had to be matched by a corresponding credit that would be reflected on their balance sheets. Where, as here, a parent company issues share options to the employees of a subsidiary, the accounting standard required the subsidiary to recognise an accounting credit (corresponding in our case to the Debit) on its balance sheet and treat that credit as a capital contribution received from the parent company (the "Capital Contribution"). The FTT described the rationale for this as follows. By issuing share options to employees of the subsidiary, a parent company was providing a benefit to its subsidiary and was in substance making an investment in its subsidiary. In a note to SWHL's accounts for the year ended 30 April 2014 (which explained a change in SWHL's accounting policy in relation to share options), it was acknowledged

that the arrangement under which Options were granted to the Companies' employees involved SWHL being regarded, for accounting purposes, as making a capital contribution to the Companies.

18. The FTT noted that this treatment might be thought odd where, as here, the subsidiary pays a Recharge to the parent of the costs of the Options that the parent had granted. However, IFRS2 made it clear that even if the costs of granting share options were being recharged, the subsidiary still had to recognise a balance sheet credit in respect of a capital contribution. Para 43D of IFRS2 dealt with the point expressly:

> "Some group transactions involve repayment arrangements that require one group entity to pay another group entity for the provision of the share-based payments to the suppliers of goods or services. In such cases, the entity that receives the goods or services shall account for the share-based payment transaction in accordance with para 43B … regardless of intragroup repayment arrangements."

*(c) The decisions below*

19. The arguments relied on by HMRC to support their contention that the Debits should not be taken into account to reduce the Companies' profits for the purpose of the charge to corporation tax are largely the same on appeal to this court as they were before the FTT, the Upper Tribunal and the Court of Appeal. Some of the arguments depend on the construction of the general provisions in Part 3 of CTA 2009 dealing with the computation of trading income, including the rules restricting deductions, and some depend on the specific provisions in Part 20 restricting deductions in respect of employee benefit contributions. The Upper Tribunal (Mann J and Judge Herrington) agreed for the most part with the conclusions reached on all the issues by the First-tier Tribunal: [2019] UKUT 111 (TCC); [2019] STC 898; [2018] BTC 513. The Court of Appeal (Patten, David Richards and Moylan LJJ) dismissed HMRC's appeal for the same reasons: [2020] EWCA Civ 663; [2020] 1 WLR 4452; [2020] STC 1201. Since we have come to the same conclusions as all the judges who have so far grappled with these issues, we do not need to set out their reasoning - it is also our reasoning and is set out below.

***Issue 1*** *- Whether disregarding the Debits is an "adjustment required or authorised by law" within the meaning of section 46(1) CTA 2009*

20. It has long been established that the profit of a taxpayer's trade is to be determined in accordance with "ordinary principles of commercial accountancy". This principle was clearly stated and explained in the judgment of Pennycuick VC in *Odeon Associated Theatres Ltd v Jones* [1971] 1 WLR 442, 453-454:

> "The effect of the principles laid down in the *Usher's Wiltshire Brewery* case and other cases, including those in which the expression 'ordinary principles of commercial accountancy' is used, is this; first, one must ascertain the profits of the trade in accordance with ordinary principles of commercial accountancy. That, of course, involves the bringing in as items of expenditure such items as would be treated as proper items of expenditure in a revenue account made up in accordance with the ordinary principles of commercial accountancy. Secondly, one must adjust this account by reference to the express prohibitions contained in the relevant statute, those being now contained in section 137 of the Income Tax Act 1952. That is to say, an item of expenditure, even if it would be allowed as a deduction in accordance with the ordinary principles of commercial accountancy, must be struck out if it falls within any of those statutory prohibitions. I believe that to be the true principle upon which the profit of the taxpayers' trade must be ascertained for the present purpose.
>
> Mr Watson, who appeared for the Crown, contended that there is a third and distinct requirement, namely that the profit of the trade must be ascertained for the purpose of income tax. It was not clear to me (I do not suppose that it is Mr Watson's fault) precisely what standard the Court should adopt, apart from that of the ordinary principles of commercial accountancy, in arriving at the profit of a trade for the purpose of income tax. Mr Watson used the word 'logic'. If by that he intended no more than to say that one must apply the correct principles of commercial accountancy, I agree with that, as I will explain in a moment. I think,

however, he intended to go beyond that and meant that the court must ascertain the profit of a trade on some theoretical basis divorced from the principles of commercial accountancy. If that is what is intended, I am unable to accept the contention, which I believe to be entirely novel.

I think that in deference to the arguments of Mr Watson and also of Mr Medd and to the authorities which were cited I ought to say a few words by way of explanation of the time-honoured expression 'ordinary principles of commercial accountancy'. The concern of the court in this connection is to ascertain the true profit of the taxpayer. That and nothing else, apart from express statutory adjustments, is the subject of taxation in respect of a trade. In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word 'correct' deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sense of the principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the court will agree with the accountants, but it will not necessarily do so. Again there may be a divergency of view between the accountants, or there may be alternative principles, none of which can be said to be incorrect, or, of course, there may be no accountancy evidence at all. The cases illustrate these various points. At the end of the day the court must determine what is the correct principle of commercial accountancy to be applied. Having done so, it will ascertain the true profit of the trade according to that principle, and the profit so ascertained is the subject of taxation. The expression 'ordinary principles of commercial accountancy' is, as I understand it, employed to denote what is involved in this composite process. Properly understood it presents no difficulty, and I would not be at all disposed to attempt any alternative label."

21. In *Revenue and Customs Comrs v William Grant & Sons Distillers Ltd* [2007] UKHL 15; [2007] 1 WLR 1448 at para 1 Lord Hoffmann described this passage as setting

out the “classic formulation” of the method of computing trading profits and stated that it had now been codified in section 42(1) of the Finance Act 1998:

> “My Lords, the method of computing trading profits for the purposes of income and corporation tax has been settled for many years. First you compute the profits on a basis which gives a true and fair view of the taxpayer's profits or losses in the relevant period. Then you make any adjustments expressly required for tax purposes, such as adding back deductions which the taxing statute forbids. The classic formulation of this method is by Sir John Pennycuick V-C in *Odeon Associated Theatres Ltd v Jones* [1971] 1 WLR 442, 453, 454 and it has now been codified in section 42(1) of the Finance Act 1998:
>
> > ‘For the purposes of Case I or II of Schedule D the profits of a trade, profession or vocation must be computed on an accounting basis which gives a true and fair view, subject to any adjustment required or authorised by law in computing profits for those purposes’”.

22. Lord Hope at para 38 described computation of profits in accordance with currently accepted accounting principles as being “the golden rule”:

> “The golden rule is that the profits of a trading company must be computed in accordance with currently accepted accounting principles. They are the best guide as to a true and fair view of the profit or loss of the company in the relevant accounting period. Profits so computed are subject to any adjustment required or authorised by law in computing those profits for corporation tax purposes. But there is no rule of law that prohibits effect being given to what currently accepted accounting principles provide as to how a true and fair view is to be arrived at …”

23. In relation to the calculation of corporation tax this “golden rule” is for our purposes set out in section 46(1) CTA 2009 as follows:

> “**46 Generally accepted accounting practice**
>
> The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes.”

24. Although HMRC accept that IFRS2 required the Companies to recognise an expense in their income statements equal to the fair value of the Options, they submit that the consequential Debits are inapt to affect the trading profits of the Companies for corporation tax purposes. If one has regard to “the archaeology” of the Debits, they arise because the Companies’ parent company, SWHL, established an EBT and the EBT Trustee granted the Options to the Companies’ employees. These transactions were treated by IFRS2 as a capital contribution (benefit) granted by SWHL to the Companies. The Debits did not represent any cost to the Companies, nor did they anticipate or reflect an actual cost which would arise in the future.

25. Mr Julian Ghosh QC for HMRC relies on two main arguments. His first argument is that no deduction is allowable and that this is “required or authorised by law” under the tailpiece to section 46 by reason of the House of Lords decision in *Lowry v Consolidated African Selection Trust Ltd* [1940] AC 648 (“*Lowry*”). In that case the taxpayer issued shares to employees at par, at a time when the market value of the shares was considerably higher. It claimed the difference between the par and market value of the shares (amounting in aggregate to £11,625) as a deduction in the calculation of its trading profits. The provision in question in *Lowry* was rule 3(a) applicable to Cases I and II of Schedule D in the Income Tax Act 1918, which provided that, in computing the profits of a trade, no sum was to be deducted in respect of “any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade”.

26. By a majority, the House of Lords held that the deduction could not be claimed. The essential reason for Viscount Caldecote LC so concluding was that “the cost to the company of earning its trading receipts was not increased by the issue of these shares at less than their full market value” (p 658). As he explained at p 657:

> “Its capital was intact after the issue of the shares: not a penny was in fact disbursed or expended. Its trading receipts were not diminished, nor do I think it is a right view of the facts to say that the respondent gave away money's worth to its own pecuniary detriment.”

27. Viscount Maugham agreed in the result on the grounds that the issue of the shares by the company "is not a trading transaction, and does not in any way affect its gains and profits" (p 669). Lord Russell of Killowen also agreed on the basis that the company "transferred neither money nor money's worth" to their employees; "they merely elected not to obtain more than the nominal value of the shares" in order to induce the employees to become shareholders in the company (p 671). Lord Wright and Lord Romer dissented.

28. Mr Ghosh submits that *Lowry* is authority for the following propositions: (1) the issue of shares by a company does not affect the profits or gains of the company for tax purposes; (2) the words "laid out or expended" imposed a requirement additional to the words "for the purposes of the trade", and (3) the taxpayer company must suffer some cost or economic burden "to its pecuniary detriment" for an expense to be treated as "laid out or expended".

29. Leaving aside the question, discussed further below, of whether it is appropriate to refer to pre-tax rewrite authority, we do not consider that *Lowry* assists HMRC. There was no finding in that case of what ordinary principles of commercial accounting then required. There was no equivalent to section 46 CTA 2009 giving statutory primacy to generally accepted accounting practice. Tax is the creature of statute and, as the citations above from *Odeon* and *William Grant* make clear, adjustments required or authorised to be made to profits calculated in accordance with generally accepted accounting principles are likely to be adjustments specified by statute. While it is possible for a judge-made rule to require or authorise such an adjustment to be made, it would have to be a rule which it is clear applies notwithstanding that the company's profits have been calculated in accordance with generally accepted accounting principles. *Lowry* provides no support for there being such a rule. Nor have we been referred to any other authority which shows there to be a relevant such rule. In addition, as Pennycuick VC pointed out in *Odeon*, there is no general theoretical basis for the courts to calculate profits other than generally accepted accounting principles.

30. Further, section 48 CTA 2009 provides:

> "48 Receipts and expenses
>
> (1) In the Corporation Taxes Acts, in the context of the calculation of the profits of a trade, references to receipts and expenses are to any items brought into account as credits or debits in calculating the profits.

> (2) It follows that references in that context to receipts or expenses do not imply that an amount has actually been received or paid.
>
> (3) This section is subject to any express provision to the contrary."

31. The Debits have been brought into account in calculating the profits in accordance with generally accepted accounting principles. As such, they are expenses for the purpose of the calculation of trading profits (section 48(1)), whether or not an amount has actually been paid (section 48(2)), subject to an "express provision to the contrary" (section 48(3)). It is an express contrary provision that HMRC therefore need to identify. We reject Mr Ghosh's argument that section 48 is not relevant as it is a definitional rather than a computational provision and its sole effect is to explain that accounts are not to be prepared on a cash basis. It is to be applied according to its terms.

32. Mr Ghosh's second argument arising from the tailpiece to section 46 is that all the authorities to which we have referred that stress that profits for corporation tax purposes should be the same as profits for accounting purposes are considering generally accepted accounting practice that is directed at ensuring that the taxpayer's profit and loss account ("P&L account") gives a true and fair picture of the profitability of the company. Mr Ghosh accepts that in so far as those accounting standards and practices mandate that certain items must be included or deducted in order for the P&L account to give a true and fair picture, then that is equally mandated for the purposes of computing corporation tax, subject to any express statutory exceptions to the contrary. But, he argues, IFRS2 has nothing to do with calculating the profits of the company. He described the requirement to recognise the Debit in the P&L account as a quirky way of including in the overall set of company accounts a matching entry for the capital contribution which is included in the balance sheet as the parent company's contribution to the business of its subsidiary. Mr Ghosh therefore seeks to distinguish between those accounting practices that are themselves directed at computing profit and those which are directed at preserving the integrity of the balance sheet. The latter are less relevant, he submits, because corporation tax is not concerned with looking at the health of the company as it appears from the total package of financial accounting documents but is focused exclusively on the company's profits as shown primarily by one of those documents; the P&L account. The parent's capital contribution is properly recorded on the balance sheet and not in the P&L account. The only reason why the matching entry finds its way onto the P&L account rather than onto the balance sheet is because of the odd combination of factors, namely that the consideration for that capital contribution is treated as the increased work by the

incentivised employees; that increased work is then treated as being consumed immediately that it is received; that means that it is not appropriate to treat it as an asset; that means that it must be treated as an expense; that means that it must be recorded in the P&L account rather than in the balance sheet.

33. We reject this argument. There is nothing in the cases cited to us, or in the taxing statute or in the accounting standards themselves that make a distinction between those accounting practices which are directed at showing a true and fair picture of profit and those which are directed at showing a true and fair picture of something else. There is no adjustment required or authorised by law to the effect that if profits in the P&L account are depressed because of an entry which is matching an entry in the balance sheet, then that is to be left out of account in calculating profits for corporation tax. Nor do we see any policy justification for drawing that distinction. On the contrary, a company's balance sheet and P&L account are not separate and severable in the way that Mr Ghosh's argument suggests because entries on one may affect entries on the other in order that, overall, they give a true and fair view of the financial state of the company. The requirements set out in IFRS2 themselves demonstrate the interrelation between the two documents by specifying that a P&L account item is matched by a balance sheet item. Further, the logic behind identifying a capital contribution from the parent in the grant of share options to the subsidiary's employees and in treating the consideration for that as the ephemeral additional services provided by the subsidiary's employees incentivised by the grant of the options is a logic that is based in the real world - that is indeed what is happening in a commercial sense. There is in our judgment no basis for ignoring those aspects of the transaction when applying section 46.

***Issue 2*** *- Whether the deduction is disallowed by section 54(1)(a) CTA 2009*

34. Section 54 provides:

> "54 **Expenses not wholly and exclusively for trade and unconnected losses**
>
> (1) In calculating the profits of a trade, no deduction is allowed for -
>
> > (a) expenses not incurred wholly and exclusively for the purposes of the trade, or

(b) losses not connected with or arising out of the trade.

(2) If an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part or identifiable proportion of the expense which is incurred wholly and exclusively for the purposes of the trade."

35. Mr Ghosh submits that section 54 disallows the deduction of the Debits on two grounds: (1) a deduction is only allowable for an expense which is "incurred" and the Debits were not so "incurred"; and/or (2) the Debits were not incurred for the purposes of a trade.

36. As to whether the Debits were expenses "incurred", Mr Ghosh points out that neither section 48, nor any other provision in CTA 2009, deems the Debits to have been "incurred" by the Companies. He submits that given that the Companies suffered no cost in relation to the Debits, the Debits cannot be said to have been "incurred" by the Companies.

37. In this connection, Mr Ghosh again seeks to rely on *Lowry* and the majority's approach in that case to what was required for expenses to be "laid out or expended", the predecessor wording to "incurred" in section 54(1)(a). Reliance is also placed on an obiter passage in the Upper Tribunal's decision in in *Ingenious Games LLP v Revenue and Customs Comrs* [2019] STC 1851, in which it was stated that the term "incurred" in section 54(1)(a) CTA 2009 is "concerned with whether the taxpayer bore the economic burden of an expense" (para 434) and that that approach "makes sense given the context of the statutory test, namely the determination of profit" (para 457).

38. We reject HMRC's case that section 54 imports a further requirement as to what constitutes an "expense", namely that it has to be shown to be "incurred". The requirements for what constitutes an expense are as set out in sections 46 and 48. These are part of Chapter 3 which is headed "Trade Profits: basic rules". Those basic rules require that it is brought into account as a debit in accordance with generally accepted accounting principles (section 46). If so, it will be an expense for the purpose of the calculation of trading profits, whether or not an amount has actually been paid (section 48(1) and (2)).

39. Section 54 is part of Chapter 4 which is headed "Trade profits: rules restricting deductions". It is not addressing how profits are to be calculated but rather what deductions are to be disallowed from profits calculated in accordance with the basic rules.

40. As the FTT stated at para 66:

> "Section 54 has to be understood in conjunction with the scheme of Chapter 3 of CTA 2009 as a whole. Section 46 makes it clear that the starting point is that profits are to be calculated in accordance with generally accepted accounting practice (subject to any adjustment required or authorised by law). Section 48 supplements that provision by providing that, if a debit is brought into account in calculating accounting profit, it is (unless there is express provision to the contrary) to be treated as an "expense" for tax purposes. The whole flavour of section 46 and section 48 is that, if a sum is properly reflected as a debit in a calculation of accounting profit, the starting point is that the sum is deductible unless there is a specific statutory rule to the contrary. If Parliament wished to deal with a category of expenses that, although properly recognised as a debit in calculating accounting profits, are not 'incurred' in the necessary sense and so not eligible for relief, I consider that it would have spelled this out explicitly and, in particular, would have set out with precision what it meant for an accounting credit to be 'incurred'."

41. The manifest purpose of section 54 is to exclude expenses incurred for a dual purpose. This is borne out by its title (which makes no reference to the incurring of expenses): "Expenses not wholly and exclusively for trade and unconnected losses". It is also borne out by the saving from the dual expense prohibition set out in section 54(2).

42. We agree with the conclusion of the FTT at para 68:

> "… when Parliament uses the word 'incurred' it does so simply as a participle that takes its colour from the word 'expenses' and does not intend to impose a free standing requirement to be applied to accounting debits …"

43. We do not consider that *Lowry* assists. That was dealing with a different statutory regime and, as the FTT observed at para 70, one which "did not accord the accounting measure of profit the status that section 46 and section 48 of CTA 2009 confer". It was also not dealing with an expense which was required to be brought into account as a debit in accordance with generally accepted accounting principles. To the extent that the Upper Tribunal indicated a contrary view obiter in the passages relied upon in *Ingenious Games*, it was wrong so to do.

44. In their written submissions, HMRC sought to justify their reliance on *Lowry* in support of their construction of section 54 because, they said, the replacement of the words "laid out or expended" in the Income Tax Act 1918 with the word "incurred" in section 54(1)(a) was not intended to effect a change in the law so that the same analysis should apply. They submitted that this approach was consistent with the approach to construction of Tax Law Rewrite Project statutes including the CTA 2009. They cited in particular the approach to pre-Rewrite case law set out by Lady Arden JSC in *R (Derry) v Revenue and Customs Comrs* [2019] UKSC 19; [2019] 1 WLR 2754. Mr Ghosh also referred to this in his oral submissions.

45. Lady Arden, in her judgment concurring with the judgment of Lord Carnwath, made some observations at paras 84-90 about the approach to the interpretation of Rewrite legislation - in that case the Income Tax Act 2007 - and to consolidation statutes more generally. Lord Carnwath (with whom Lord Reed, Lady Black and Lord Kitchin JJSC agreed) at para 9 of his judgment set out a passage from *Eclipse Film Partners (No 35) LLP v Revenue and Customs Comrs* [2013] UKUT 639 (TCC); [2014] STC 1114, para 97 which had likened the correct approach to the interpretation of Tax Rewrite legislation to that appropriate to a consolidation statute, as explained by the House of Lords in *Farrell v Alexander* [1977] AC 59. That emphasised that a consolidating statute should be construed as a single integrated body of law without the need to refer back to the same provisions as they appeared in earlier legislative versions. Sales J in *Eclipse* said that to refer back constantly to previous provisions to determine their meaning would undermine an important part of the objective of a consolidating statute or of a project like the Tax Law Rewrite Project, which is to gather disparate provisions into a single, easily accessible code. Lord Carnwath in *Derry* at paras 9 and 10 endorsed that guidance which should, he said, be read subject to Lady Arden's observations, while emphasising also that the resulting statutes are intended to be relatively easy to use, not just by professionals but also by the reasonably informed taxpayer.

46. At para 88 of her judgment, Lady Arden expressed the view that the restraint required by the House of Lords in *Farrell v Alexander* related to referring back to legislative history but not to relevant antecedent case law. Reference back to earlier

case law did not, Lady Arden said, undo the good work done by consolidation or run counter to it.

47. Lady Arden's comments were not necessary for determination of the appeal in *Derry* and the effect of *Farrell v Alexander* regarding reference to the case law interpreting statutory provisions as they appeared prior to consolidation was not the subject of any written or oral submissions in *Derry*. It is not necessary in the present appeal to consider whether what was said in *Derry* is consistent with what was said about consolidation statutes in *Farrell v Alexander* nor how that would apply to a Tax Law Rewrite Project statute. In the present case, the use of the word 'incurred' is different from the earlier wording considered in *Lowry*; it is a plain English word that is unambiguous and can be construed satisfactorily in its context without the need to consider any glosses or baggage that might have attached itself to the earlier, pre-Rewrite provisions. However, given the prominence which the comments of Lord Carnwath and Lady Arden in *Derry* were given in parts of HMRC's submissions, we think we should sound a note of caution that in a future case it may be necessary to give further consideration, with the benefit of submissions on the issue, as to whether and when it is appropriate to refer to earlier case law either in relation to a consolidation statute properly so called or to a Tax Law Rewrite Project statute.

48. Turning to whether the Debits were incurred for the purposes of trade within the meaning of section 54, HMRC contend that in circumstances where the Debits arose from a transaction to which the Companies were not parties and over which, on the evidence, the Companies had no control, it is impossible to ascribe any "purposes" to the Debits on the part of Companies at all.

49. We consider that the purpose for which the Debits was incurred is conclusively determined by the findings made by the FTT as follows:

> "74. The relevant circumstances are that the Appellants carry on trades that involve employing staff and making those staff available to other group companies. The profits of that trade come from the fact that the Appellants charge a margin over and above their employees' payroll costs. The Appellants' employees operate in a professional services business whose success depends on the availability of skilled and motivated professionals and the grant of share options to those employees is part of their remuneration package. The IFRS2 Debit arises only because options have been granted to the Appellants' employees. Moreover, as noted at [13], the Appellants charge group companies an amount

> corresponding to the IFRS2 Debit (appropriately marked up) when making employees available to them, and therefore the incurring of the IFRS2 Debit has a direct link with the earning of revenue profits. There is no suggestion that the options were granted, and the IFRS2 Debit thus incurred, for any ulterior motive not related to the Appellants' trades.
>
> 75. I also consider that it is relevant that the Appellants were prepared to pay SWHL (under the Recharge arrangement). I agree with Mr Ghosh that any deduction that the Appellants obtain has to be in respect of the IFRS2 Debit and not for sums paid under the Recharge arrangement for the simple reason that the payment of sums under the Recharge did not result in any expense in the Appellants' income statements. I do not think it matters whether the grant of the options involved SWHL incurring any cost (or whether the Recharge arrangement should more accurately be described as a 'charge'). The Recharge demonstrates that the Appellants thought that they were obtaining a benefit from the grant of options sufficient to warrant them paying an amount equal to the fair value of those options to SWHL which further suggests that the IFRS2 Debit (which arose only because the options were granted) was incurred wholly and exclusively for the purposes of SWHL's trade. In addition, as noted at para 22, the IFRS2 Debit is intended, as an accounting matter, to represent a measure of the value of employees' services that the Appellants consume in return for the grant of share options. The Appellants consume those services in the course of the trades that they conduct.
>
> 76. For all of those reasons, I consider that taking a realistic view of the facts, the IFRS2 Debit was incurred wholly and exclusively for the purposes of the Appellants' trades."

50. The FTT's conclusion as to the purposes for which the Debits were incurred is a finding of fact which was open to it. No grounds for challenging that finding have been made out. As the Court of Appeal held at para 54:

> "As the FTT found, the debits in this case were required by IFRS 2 to reflect the consumption by the taxpayers of the

> services provided by the employees, who were in part remunerated by the grant of the options. The taxpayers consumed those services wholly and exclusively for the purposes of their trades, being the provision of their employees' services to other group companies at a profit. It follows that the purpose requirement of section 54(1)(a) was satisfied."

51. We therefore agree with the court and tribunals below that the deduction is not disallowed by section 54(1)(a) CTA 2009.

***Issue 3*** *- Whether the deduction is disallowed by section 53 CTA 2009, which provides that no deduction is allowed for "items of a capital nature"*

52. Section 53 CTA 2009 provides:

> "53 **Capital expenditure**
>
> In calculating the profits of a trade, no deduction is allowed for items of a capital nature …"

53. HMRC rely upon IFRS2 Basis of Conclusion 31 which provides:

> "BC31 The rationale for recognising all types of share-based payment transactions - irrespective of whether the equity instrument is a share or a share option, and irrespective of whether the equity instrument is granted to an employee or to some other party - is that the entity has engaged in a transaction that is in essence the same as any other issue of equity instruments. In other words, the entity has received resources (goods or services) as consideration for the issue of shares, share options or other equity instruments. It should therefore account for the inflow of resources (goods or services) and the increase in equity. Subsequently, either at the time of receipt of the goods or services or at some later date, the entity should also account for the expense arising from the consumption of those resources."

54. They submit that the logic of the treatment mandated by IFRS2, as explained in BC31, is that the issue of shares or share options to employees should be accounted for analogously with any other issue of equity instruments. The accounting debit in respect of the notional "consumption of services" is simply the corresponding entry required to balance the increase in equity resulting from the capital contribution from SWHL and arises only because the thing received by the Companies on the capital contribution (ie employee services) does not qualify for recognition as an asset. It follows that, even if the Debits are properly viewed as an "expense incurred" by the Companies, they were items of a capital nature within the meaning of section 53 CTA 2009 and so may not be deducted.

55. The FTT findings at paras 74-75 set out above are also relevant to this issue. As the FTT found at para 74: "The Appellants' employees operate in a professional services business whose success depends on the availability of skilled and motivated professionals and the grant of share options to those employees is part of their remuneration package". As the FTT further found at para 81:

> "… the IFRS2 Debits arose because the Appellants' employees were remunerated with share options and the remuneration of employees has a revenue, not a capital, nature. The IFRS2 Debits arose periodically, they were not 'one off' items. The IFRS2 Debits were therefore recurring costs that had a connection with the Appellants' earning of income (not least since the Appellants on-charged the IFRS2 Debits to other members of the Group, at a margin, by way of the Management Charge). In addition, as an accounting matter, the IFRS2 Debits reflect the consumption of employees' services by the Appellants. That also is redolent of the IFRS2 Debits being revenue in nature, and not capital."

56. These are compelling reasons for holding that the Debits are not capital in nature. The fact that the matching credit entry was a capital contribution does not change that. What matters is the character of the Debits, not that of any corresponding credit. For the reasons given by the FTT, these were revenue in nature, not capital.

57. We therefore agree with the court and tribunals below that the deduction is not disallowed by section 53(1) CTA 2009.

***Issue 4****: Whether the deduction is disallowed (or deferred) by section 1290 CTA 2009*

58. Section 1290 CTA 2009 falls within Chapter 1 of Part 20 which deals with restrictions of deductions. It is the first of eight sections dealing with employee benefit contributions. Section 1290(1) defines the deduction to which the section applies as a deduction which would otherwise be allowable when calculating the company's profits in a period of account, if that deduction is a deduction in respect of employee benefit contributions made or to be made. If a deduction falls within section 1290(1) then according to subsection (2) the deduction is only allowable in two circumstances. The circumstances relevant for our purposes are those described in section 1290(2)(a), namely that a deduction will be allowed if qualifying benefits are paid out of contributions during the accounting period or within nine months of the end of that period. If the deduction is prevented from being included in the accounting period by section 1290(2), it can still be allowed in a later period if qualifying benefits are provided out of the contributions before the end of that later period: see subsection (3). Subsection (4) then carves out from the section a list of specified deductions that are allowable such as contributions to pension schemes or accident benefit schemes. None of those exclusions is relevant for our purposes.

59. The relevant wording of section 1290 (as it applied in the relevant accounting years) is thus as follows:

> "1290 **Employee benefit contributions**
>
> (1) This section applies if, in calculating for corporation tax purposes the profits of a company ('the employer') of a period of account, a deduction would otherwise be allowable for the period in respect of employee benefit contributions made or to be made (but see subsection (4)).
>
> (2) No deduction is allowed for the contributions for the period except so far as -
>
> > (a) qualifying benefits are provided, or qualifying expenses are paid, out of the contributions during the period or within nine months from the end of it …"

60. The term "employee benefit contribution" is defined in section 1291:

> "**1291 Making of 'employee benefit contributions'**

(1) For the purposes of section 1290 an ‘employee benefit contribution’ is made if, as a result of any act or omission -

(a) property is held, or may be used, under an employee benefit scheme, or

(b) there is an increase in the total value of property that is so held or may be so used (or a reduction in any liabilities under an employee benefit scheme).

(2) For this purpose ‘employee benefit scheme’ means a trust, scheme or other arrangement for the benefit of persons who are, or include, present or former employees of the employer or persons linked with present or former employees of the employer.”

61. The FTT described section 1290 as seeking to ensure that there is broad symmetry between the time at which a company obtains relief for an “employee benefit contribution” and the time at which the employee receives taxable “qualifying benefits” out of that contribution: see para 56 of the FTT judgment. However, it was common ground that the act of granting share options to employees did not involve employees receiving “qualifying benefits” on which they have to pay tax, largely because of section 475 of the Income Tax (Earnings and Pensions) Act 2003. That provision provides that the grant of an option to employees does not give rise to an income tax charge for those employees.

62. The issue is therefore how to apply the definition in section 1291 to the option schemes operated by SWHL and the Companies. The putative “employee benefit contribution” here is the grant of the share options to the employees. Those grants will be “employee benefit contributions” if they result in property being held or used under an employee benefit scheme. Mr Ghosh argued that the grant of options fell within section 1291 and hence the Debits were disallowed by section 1290 in two ways. The first way looked at the shares in SWHL held by the EBT Trustee when it buys them in order to meets its obligations to employees who exercise their options. Mr Ghosh argued that those shares are “property”, and that the EBT Trustee is holding that property under an employee benefit scheme. Further, it is holding those shares as a result of the employee benefit contributions, that is to say, as a result of the grant of options by the Companies to their employees. The second way was to look at the Options (rather than the shares) as the “property” for the purposes of section 1291.

Those Options should, he submitted, be regarded as property which, once granted, were held by the employees as a result of the employee benefit contribution and, further, the Options were held by the employees under an arrangement which constitutes an employee benefit scheme.

63. If either of those contentions was well made, then any deduction, including the Debit in respect of those employee benefit contributions would not be deductible or at least would be deferred until qualifying benefits were provided - and since the Options are not qualifying benefits and many Options are never exercised, the deduction would in such cases not only be deferred but would never be allowable.

64. The FTT held that neither route proposed by HMRC worked; the Debit was not in respect of an employee benefit contribution and so was not caught by section 1290. If one looks at the Options as the "property", the FTT held that once the Options had been granted to the employees they were theirs absolutely and were not "held" or "used" under an employee benefit scheme: "When the employees received their options, they had received their benefit and those options were no more held 'under' an employee benefit scheme after they were granted than was an employee's salary": para 98.

65. If the "property" referred to in the definition in section 1291 is the shares themselves, then the FTT held that the fact that the EBT Trustee needed to obtain shares to meet its contractual obligations when the options were exercised did not mean that those shares were to be held by the EBT Trustee "under" the employee benefit scheme in the necessary sense. The shares were not acquired to confer a benefit on the employees because any benefit had already been provided in the form of the Option which was granted by the Companies. The EBT Trustee acquired the shares in order to fulfil its contract - it was not conferring some benefit on the employees in addition to the benefit already conferred on them by their employer. Further, the FTT concluded on the facts that the grant of the Options (that is to say, the conferring of the employee benefit contribution) did not really "result" in the EBT Trustee holding the shares in SWHL or holding an increased value of shares. Significant numbers of Options would lapse unexercised for various reasons and the EBT Trustee would not acquire shares to satisfy them. The FTT was not satisfied on the evidence that there was the necessary causal link between the grant of any particular Option and the EBT Trustee's acquisition of shares to enable one to conclude that the EBT acquired shares or an increased value of shares as a 'result' of the grant of any particular Option.

66. The FTT (at para 101) regarded this result, namely that the deduction of the Debit was not disallowed by section 1290, as consistent with the overall purpose of section 1290:

> "Section 1290 is not seeking to establish a general principle that a company is denied a corporation tax deduction whenever it makes outright payments to employees that are not subject to tax in the employees' hands. If that were the purpose of section 1290, it could have been expressed much more briefly. Rather, section 1290 is concerned with situations in which an employer incurs expenses in putting property into an arrangement that can be expected (in due course) to result in employees receiving benefits but the corporation tax deduction is taken before employees are subjected to a tax liability on their benefit. That is emphasised by the fact that section 1290(2) permits a deduction to be given where qualifying benefits are provided 'out of' employee benefit contributions (suggesting that an employee benefit contribution is something other than an outright transfer to employees). It is also emphasised that by the fact that the definition of 'employee benefit arrangement' envisages that there is some sort of intermediary arrangement standing between the provision of property by the employer and the receipt of benefits by the employee. The options arising in this appeal were not within the evident purpose of section 1290: as noted above, as soon as the EBT Trustee granted the options, the employees received their benefit (consisting of the option itself) and no further action was needed for them to receive that benefit."

67. The Upper Tribunal agreed with the FTT's reasoning: para 113 of their judgment. The Court of Appeal recognised that a literal reading of section 1291(1) was capable of leading to the conclusion for which HMRC contended but held that this would be to ignore the context of section 1290: para 77. That context was that the term 'employee benefit contribution' although defined in section 1291 was not an empty vessel or algebraic symbol but a term with a natural meaning which informed the circumstances in which the provisions were intended to apply. The term suggested a payment from which benefits would be provided by employees. But here the benefit was the option itself entitling the employees to acquire shares at a price that might be less than the market value. The option and that potential bargain was not an employee benefit contribution within the meaning of the term and section 1290 did not therefore apply.

68. Before this court, Mr Ghosh renewed the arguments he had made before the Court of Appeal. It was common ground that the Debit arose "as a result of" the grant of the Options. He accepted that the share option scheme in the present case was not the paradigm situation at which sections 1290 and 1291 were directed. The paradigm was when the employer pays money into a fund or scheme and some time later, that money is paid out to employees. The cost of putting the money in the scheme is only an allowable deduction once it has been paid out to the employees. In addition, he argued that one could apply the provisions by regarding the Options themselves as the "scheme" within the meaning of section 1291(2) - the Options being of themselves arrangements for the benefit of the employees.

69. Mr Ghosh submitted that the tribunals and court below had been unduly influenced by the fact that the general purpose of section 1290 was only to defer the allowable deduction, not to rule it out, and that on HMRC's case the Debits would be deferred indefinitely because they never resulted in a qualifying benefit being provided. He referred to the speech of Lord Hoffmann in *MacDonald (Inspector of Taxes) v Dextra Accessories Ltd and others* [2005] UKHL 47; [2005] 4 All ER 107 ("*Dextra*") as showing that this concern was misplaced. In *Dextra* Lord Hoffmann was construing section 43 of the Finance Act 1989 which was the predecessor provision to section 1290, though worded very differently. In that case the employer set up an EBT into which it paid £2.75m at the end of the tax year. No payments out were made to employees in that tax year but most of the money was paid out during the following year. The Revenue argued that the employer's payment into the fund was non-deductible because it was a "potential emolument" and could only be deducted as and when the funds had been applied in the payment of emoluments. The House of Lords held that the payment into the fund was not deductible. Lord Hoffmann said at paras 20 and 21 :

> "20 It is true that the effect of the Revenue's construction is that unless the funds are at some point applied in the payment of relevant emoluments, they never become deductible at all. This was identified by the Special Commissioners and Neuberger J as an anomaly unfair to the taxpayer. … As Jonathan Parker LJ observed, it is the result of an arrangement into which the taxpayers have chosen to enter. Any untoward consequences can be avoided by segregating the funds held on trust to pay emoluments from funds held to benefit employees in other ways. …
>
> 21 On the other side, there would be other anomalies in the construction favoured by the Special Commissioners and

> the judge. By setting up a trust such as this, the taxpayer could achieve immediate deductibility of payments into the trust and postpone indefinitely the liability of employees to tax on the emoluments for which, in part, the money was eventually applied. That would enable the purpose of section 43 to be easily frustrated".

70. On this issue we hold that section 1290 does not apply here because the grant of the Option is not an "employee benefit contribution" within the meaning of section 1291 and hence the Debit is not a deduction in respect of an employee benefit contribution for the purposes of section 1290. Once the Options are granted by the Companies to the employees as part of their remuneration package, their purpose is spent so far as the Companies are concerned. The Option is not a "potential" emolument - the phrase used in the predecessor section 43 of the Finance Act and discussed in *Dextra*. It is an actual emolument and the Options are not, once granted, "held" by the employees under the employee benefit scheme even though the scheme will have set the terms on which they can be exercised in future and even though the deduction of the Debit in respect of them is spread across the vesting period.

71. If one considers the shares as the contribution, we agree with the FTT that the causal link between the grant of the Options by the Companies and the acquisition from time to time of shares by the EBT Trustee is not sufficient to bring this arrangement within the scope of the provisions.

72. We do not agree that the Option can itself be an "other arrangement" and hence an employee benefit scheme within section 1291(2). The term "other arrangement" must be something akin to a trust or scheme and an option is not such an arrangement.

73. We have not been influenced in our interpretation by a desire to avoid the Debits being indefinitely deferred and we accept that there may be cases falling within section 1291 where in the event the deduction never becomes allowable, as was envisaged by Lord Hoffmann in *Dextra*. But we also do not accept Mr Ghosh's underlying policy argument that we should strive to apply section 1290 to disallow the deduction of the Debits because the Options are not taxable qualifying benefits in the hands of the employees. We do not accept his description of sections 1290-1297 as a statutory code aimed at ensuring that relief for employee benefit contributions is only available if and when matched by a corresponding charge to income tax and national insurance contributions. On the contrary, Parliament has adopted a policy of encouraging employee share option schemes by providing that the options do not create a charge to income tax. In so giving with one hand, it does not appear to have

taken away with the other hand by defining ‘employee benefit contribution’ in a way which has the effect of disincentivising employers by disallowing the deduction of the Debit as an expense in calculating corporation tax profits. The source and evolution of this provision set out in HMRC’s written case does not support the contention that it was intended to apply to the present circumstances.

**Conclusion**

74. For the reasons set out above, we dismiss HMRC’s appeal.