HOUSE OF LORDS SESSION 2005–06
[2005] UKHL 47

on appeal from: [2004] EWCA Civ 22

OPINIONS

OF THE LORDS OF APPEAL

FOR JUDGMENT IN THE CAUSE

MacDonald (Her Majesty's Inspector of Taxes (Respondent)
v.
Dextra Accessories Limited (Appellants)

Appellate Committee

Lord Nicholls of Birkenhead
Lord Hoffmann
Lord Hope of Craighead
Lord Scott of Foscote
Lord Walker of Gestingthorpe

Counsel

Appellants:
Andrew Thornhill QC
Jonathan Peacock QC
Rupert Baldry
(instructed by Levy Watters)

Respondents:
Timothy Brennan QC
David Ewart
(instructed by HM Revenue and Customs)

Hearing date:
22 June 2005

ON
THURSDAY 7 JULY 2005

HOUSE OF LORDS

OPINIONS OF THE LORDS OF APPEAL FOR JUDGMENT IN THE CAUSE

MacDonald (Her Majesty's Inspector of Taxes (Respondent) *v.* Dextra Accessories Limited (Appellants)

[2005] UKHL 47

LORD NICHOLLS OF BIRKENHEAD

1. I have had the advantage of reading in draft the speech of my noble and learned friend Lord Hoffmann. For the reasons he gives, with which I agree, I would dismiss this appeal.

LORD HOFFMANN

My Lords,

2. Until 1989 the emoluments of an office or employment were taxed under Schedule E as income of the year of assessment in which they were earned. It did not matter when they were paid: see *Heasman v Jordan* [1954] Ch 744. On the other hand, for the purpose of computing his profits taxable under Schedule D, an employer was entitled to deduct his liability to pay emoluments to employees in the year in which, in accordance with normal accounting principles, that liability accrued.

3. Section 37 of the Finance Act 1989, which inserted new sections 202A and 202B into the Taxes Act 1988, changed the basis of Schedule E assessment from the year in which emoluments were earned to the year in which they were paid. This gave rise to the possibility of a delay in payment causing a substantial timing disparity between the year in which the emoluments were deductible by the employer and the year in which they were taxable in the hands of the employee. Particularly in a case in which employer and employee were closely associated, for example, as a company and its directors, the tax liability of the company

could be reduced without creating an immediate personal liability on the part of the directors.

4. Section 43 of the 1989 Act was intended to deal with this situation. It is necessary to refer only to a few subsections:

> "43.(1) Subsection (2) below applies where –
>
> (a) a calculation is made of profits or gains which are to be charged under Schedule D and are for a period of account ending after 5th April 1989,
>
> (b) relevant emoluments would (apart from that subsection) be deducted in making the calculation, and
>
> (c) the emoluments are not paid before the end of the period of nine months beginning with the end of that period of account.
>
> (2) The emoluments –
>
> (a) shall not be deducted in making the calculation mentioned in subsection (1)(a) above, but
>
> (b) shall be deducted in calculating profits or gains which are to be charged under Schedule D and are for the period of account in which the emoluments are paid.
>
> (10) For the purposes of this section, 'relevant emoluments' are emoluments for a period after 5th April 1989 allocated either –
>
> (a) in respect of particular offices or employments (or both) or
>
> (b) generally in respect of offices or employments (or both).
>
> (11) This section applies in relation to potential emoluments as it applies in relation to relevant emoluments, and for this purpose-
>
> (a) potential emoluments are amounts or benefits reserved in the accounts of an employer, or held by an intermediary, with a view to their becoming relevant emoluments;
>
> (b) potential emoluments are paid when they become relevant emoluments which are paid.
>
> (12) In deciding for the purposes of this section whether emoluments are paid at any time after 5th April 1989, section 202B of the Taxes Act 1988 (time when emoluments are treated as received) shall apply as it

applies for the purposes of section 202A(1)(a) of that Act, but reading 'paid' for 'received' throughout."

5. The core of this provision is in subsections (1) and (2). The old rule that emoluments may be deducted in the year in which, on ordinary accounting principles, liability to pay them has accrued, is to apply only if they are actually paid during that year or within a grace period of nine months thereafter. Otherwise they may be deducted only in the year in which they are paid. Thereby the possibility of a substantial timing disparity between deduction by the employer and payment to the employee is avoided.

6. This basic rule of non-deductibility without actual payment applies to "relevant emoluments", defined in subsection (10) as emoluments which have been "allocated" in respect of a particular office or employment or generally in respect of offices or employments. "Allocated" presumably means allocated in drawing up the accounts, as sums for which a liability to pay emoluments is regarded on accounting principles as having accrued.

7. Subsection (11) then extends this rule of non-deductibility to "potential emoluments" as defined. The question in this appeal is whether certain payments made by the taxpayer companies to an employee benefit trust ("EBT") were potential emoluments within the meaning of section 43(11)(a).

8. The taxpayer companies are members of a group trading in mobile telephones and related services founded by Mr John Caudwell. The EBT was established by a deed executed on 18 December 1998 by Caudwell Holdings Ltd, a group company, as settlor and a Jersey company as trustee. It recites that the settlor is desirous of making an irrevocable settlement "with a view to encouraging and motivating employees." The beneficiaries are defined as the present and future officers, employees and former officers and employees of any group company, their spouses, widows, widowers, children, remoter issue and other dependents.

9. The deed confers upon the trustee a wide discretion over capital and income to pay money and other benefits (including pensions) to any of the named beneficiaries and a power to lend them money. The discretion is said to be absolute and uncontrolled but the trustees are

entitled to take into account the recommendations of the directors of the settlor or other group companies. At the end of the trust period there is a discretionary trust for the beneficiaries with a gift over to charity.

10. On 21 December 1998 the six appellant companies paid a total of £2.75m to the trustees to be held on the trusts of the settlement. Under the trusts which I have described, the trustees had power to use these funds in paying emoluments to employees but also power to make payments which are not emoluments.

11. In the event, no payments of any kind were made to beneficiaries before 31 December 1998, when the taxpayer companies' accounting year ended. During 1999 most of the £2.75m was allocated in accordance with the recommendations of the directors to employees, part in the form of emoluments and part in other forms.

12. There is no dispute that on ordinary accounting principles the £2.75m was deductible in computing the profits of the taxpayer companies in the year ended 31 December 1998. But the Inland Revenue say that it was a potential emolument within the meaning of section 43(11)(a) because, under the terms of the trust, it could have been used to pay emoluments. The funds were held by an intermediary, the trustee, "with a view to their becoming relevant emoluments". The rule of non-deductibility therefore applies until and insofar as the funds have been applied in the payment of emoluments.

13. The Special Commissioners (Dr John F Avery Jones and Edward Sadler) [2002] STC (SCD) 413 rejected the Revenue's argument. They said that funds were held "with a view to becoming relevant emoluments" only if the purpose of the contributing company was that they should be used to pay emoluments. In this case, the terms of the trust deed showed that the contributing companies had other purposes as well.

14. On appeal, Neuberger J [2003] EWHC 872 (Ch); [2003] STC 749 upheld the Special Commissioners. He did not agree that the purpose for which the companies made the payments was decisive. The question was whether they were held by the intermediary, the trustee, with a view to becoming relevant emoluments. That depended primarily upon the terms of the trust, read against the surrounding circumstances, rather than the purposes of the contributors. Nor did he agree that the

exclusive purpose had to be the payment of emoluments. But he said that it had to be the principal or dominant intention of the trust. On the facts, the trust deed did not demonstrate such an intention.

15. The Court of Appeal (Potter and Jonathan Parker LJJ and Charles J) [2004] EWCA Civ 22; [2004] STC 339 accepted the submissions of the Revenue and allowed the appeal. Jonathan Parker LJ said, first, that if Parliament had intended that the funds should be held, as the Special Commissioners thought, *for the sole purpose* of paying emoluments, or as Neuberger J thought, *with the principal or dominant intention* of paying emoluments, Parliament would no doubt have used such expressions, which are by no means unfamiliar in tax legislation. Furthermore, the notion of the trustees having an intention, dominant or otherwise, in respect of the use of the fund in advance of an occasion to exercise their discretionary powers would be artificial and possibly unlawful. Their only intention would be to act (if at all) within the powers conferred by the deed. So the question must be answered solely by reference to the terms of the deed, construed no doubt in the light of any relevant background.

16. Secondly, Jonathan Parker LJ pointed out that the subsection is concerned with what may happen in the future, rather than (as in some other statutes which used the expression "with a view to") an examination of the reasons, motives or purposes with which some action was done in the past. That element of futurity, combined with the statutory label "potential" emoluments, suggested that Parliament was concerned simply with what might realistically happen.

17. The Court of Appeal therefore decided that the funds were held with a view to becoming relevant emoluments if they were held on terms which allowed a realistic possibility that they would become relevant emoluments.

18. I agree with the Court of Appeal, largely for the reasons given by Jonathan Parker LJ. In the ordinary use of language, the whole of the funds were potential emoluments. They could be used to pay emoluments. It is true that, as Charles J pointed out, "potential emoluments" is a defined expression and a definition may give the words a meaning different from their ordinary meaning. But that does not mean that the choice of words adopted by Parliament must be wholly ignored. If the terms of the definition are ambiguous, the choice of the term to be defined may throw some light on what they mean.

19. As the Court of Appeal noted, the words "with a view to their becoming relevant emoluments" apply both to the purpose for which amounts are held by an intermediary and also to the purpose for which they are "reserved in the account of an employer". The words must have a similar meaning in both contexts. What, therefore, are potential emoluments reserved in the account which are properly deductible in computing the profits of the employer (subsection (1)(b)) but are not already relevant emoluments? Mr Thornhill QC, who appeared for the taxpayers, said that relevant emoluments were contractually or constructively payable, whereas a reserve should properly be made for potential emoluments because they are payable only upon the occurrence of a contingency; for example, a bonus payable if a certain profit is achieved. It seems to me, however, that if that is a correct description of potential emoluments for which a reserve has been made, it would be equally true to say that amounts held by an intermediary were for the payment of emoluments upon a contingency, namely the exercise of a discretion by the trustees. In both cases, the sums in question may or may not be used to pay emoluments but there is at least a realistic possibility that they will be.

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. But precisely that result has been achieved by section 143 and Schedule 24 of the Finance Act 2003, which replaced section 43(11)(a) shortly after (and possibly in response to) the decision of the Special Commissioners. The anomaly and unfairness has therefore not troubled a more recent Parliament and may not have troubled the Parliament of 1989. 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.

22. I would therefore dismiss the appeal.

LORD HOPE OF CRAIGHEAD

My Lords,

23. I have had the advantage of reading in draft the speech of my noble and learned friend Lord Hoffmann. I agree with it, and for the reasons he has given I too would dismiss the appeal.

LORD SCOTT OF FOSCOTE

My Lords,

24. I have had the advantage of reading in advance the opinion on this appeal of my noble and learned friend Lord Hoffmann and for the reasons he has given, with which I agree, I too would dismiss this appeal.

LORD WALKER OF GESTINGTHORPE

My Lords,

25. I have had the advantage of reading in draft the opinion of my noble and learned friend Lord Hoffmann. For the reasons he has given, with which I agree, I too would dismiss this appeal.