Recent pensions UK tax cases

Received: 10th September, 1999

Daniel Schaffer

is a partner in Freshfields' employment, pensions and benefits group, based in London. He has wide experience of pensions work including scheme establishment, merger and winding up, senior executive remuneration, fund investment, High Court litigation and the implications of privatisation. He also advises on the employment and pensions aspects of acquisitions, IPOs and demutualisations. He is a member of the international committee of the Association of Pension Lawyers, the Trust Law Committee and he sat on the Financial Law Panel's working party on trustee creditors. He taught trust law at Oxford University for five years.

Daniel was educated at Bristol University (LLB) and Oxford University (BCL) and joined the partnership in 1998.

Isobel Carruthers

studied law at Exeter and Oxford Universities and is now a trainee solicitor at Freshfields.

Abstract This paper will cover two recent pensions tax issues which have been judicially considered:

- whether commissions from sub-underwriting by pension funds are taxable (*Clarke (Inspector of Taxes) v. Trustees of the British Telecom Pension Scheme and others* [1998] All ER 453); and
- whether tax paid under section 601 Income and Corporation Taxes Act 1988 is recoverable where the underlying transaction was invalid and reversed (*Hillsdown Holdings plc v. Inland Revenue Commissioners* [1999] STC 561).

This paper is based on a presentation at the Fifth Annual Occupational Pensions Law Reports Conference, 2nd July, 1999.

Keywords: *sub-underwriting and pension schemes; tax refunds on invalid transactions*

Sub-underwriting commissions and pension funds

- what are the tax consequences?
- how safe is it to sub-underwrite now?

Sub-underwriting by pension funds

The first part of the paper on the tax implications for pension funds of sub-underwriting is structured as follows:

- what is sub-underwriting?
- the background to the Revenue challenge
- tax implications of trading rather than investing — the legislation
- the legal story so far
- what is trading in the context of sub-underwriting?

What is sub-underwriting commission?

Sub-underwriting commissions arise in a variety of contexts. A company listed on the London Stock Exchange might wish to raise additional finance by means of a rights issue, where existing shareholders are given the opportunity to subscribe for shares in proportion to their existing holdings at a discount (usually about 15 per cent).

An unquoted company might wish to obtain a Stock Exchange listing through

Dan Schaffer and Isobel Carruthers
(Employment, Pensions and Benefits Department, Freshfields, Whitefriars, 65 Fleet Street, London EC4Y 0NH.

Tel: 020 7936 4000; Fax: 020 7832 7001)

a new issue of shares (an initial public offering). A listed company might wish to bid for another company offering new shares with a cash alternative.

Where finance is raised by means of a rights issue or an initial public offering, the company needs to ensure that all the new shares are subscribed if it is to raise all the capital it requires. The price is usually fixed at a level designed to ensure success. However, between the date of offer and the last acceptance date, either the market generally might fall or the particular shares might fall, resulting in undersubscription.

In a bid situation undersubscription may arise if shareholders opt for the cash alternative. Companies, therefore, cover the risk that the share may not be taken up by paying a commission to an underwriter (2 per cent) who contracts to subscribe for any shares not taken up. The underwriter typically off-lays his risk by inviting institutional investors such as pension funds, unit trusts and insurance companies to agree, for a commission (1.25 per cent), to purchase a proportion of the unsold shares at the issue price.¹

The background to the Revenue challenge

The dispute in relation to the BT and Post Office funds had been rumbling on since 1983. The OFT commissioned a report, published in November 1994, which concluded that commissions received by sub-underwriters on rights issues exceeded the value of the insurance provided. Immediately following the report, it became known that the Inland Revenue began scrutinising commissions earned by pension funds more closely. A number of schemes had 'open assessments' pending appeal, and back in 1994 the Revenue were already talking about a test case.

In 1996 the NAPF Investment

Committee met the Treasury to secure clarity that generally underwriting commission would not attract taxation. The meeting was not entirely successful. At that stage the Revenue confirmed simply that it continued to have regard to the Investment Committee Bulletin No. 8 of 8th June, 1991 but it could not be determinative of all situations.

Tax implications of trading rather than investing — the legislation²

Section 592 of Part XIV of the Taxes Act

This section gives exemption from income tax to certain income of exempt approved occupational pension schemes. It provides:³

- '(2) Exemption from income tax shall ... be allowed in respect of income derived from investments or deposits if ... it is income from investments or deposits held for the purposes of the scheme.
- (3) Exemption from income tax shall ... be allowed in respect of underwriting commissions if ... the underwriting commissions are applied for the purposes of the schemes and would, but for this subsection, be chargeable to tax under Case VI of Schedule D.'

Case VI reads:

'tax in respect of any annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or E'.

Case I reads:

'tax in respect of any trade carried on in the United Kingdom'

Section 686 of Part XV of the Taxes Act

This section imposes a liability to additional rate tax on certain income of discretionary trusts. The relevant parts are:⁴

- (1) So far as income arising to trustees is income to which this section applies it shall be chargeable to income tax at the rate applicable to trusts, instead of at the basic rate or, in accordance with section 1A, at the lower rate.
- (1A) The rate applicable to trust in relation to any year of assessment for which income tax is charged, shall be 34 per cent or such other rate as Parliament may determine; and, for the purposes of assessment for the year 1993–94 and in relation to years of assessment for which tax at the basic rate and the additional rate was separately chargeable, references to the charging of income with tax at the rate applicable to trusts shall be taken to include references to the charging of income with tax both at the basic rate and at the additional rate.
- (2) This section applies to income arising to trustees in any year of assessment as far as it:
-
- (c) is not income ... from investments, deposits or other property held
- (i) for the purposes of a fund or scheme established for the sole purpose of providing relevant benefits within the meaning of section 612.

The additional rate is currently 34 per cent.

The legal story so far

The Inland Revenue assessed the trustees of three of the UK's largest pension schemes (British Telecom Pension Scheme (BTPS), Post Office Staff Superannuation Scheme (POSSS) and Post Office Pension Scheme), for income tax of £13m in respect of sub-underwriting commissions received by the trustees in years 1983–1995.

The trustees appealed to the Special Commissioners and their appeal was upheld in December 1997. The Inland Revenue appealed the decision in the

High Court. Lightman J (*Clarke (Inspector of Taxes) v. Trustees of the British Telecom Pension Scheme and others* [1998] All ER 453) allowed the appeal in favour of the Revenue in October 1998. An appeal is expected to be heard by the Court of Appeal some time in 2000.

What is trading in the context of pension fund sub-underwriting?

Whether commissions from particular sub-underwriting contracts amount to trading depends, according to Lightman J:

- (i) not on s. 592(3) providing a more lenient test for what constitutes trading; but rather the answer is determined by a two-stage test:

‘Exemption from income tax shall ... be allowed in respect of underwriting commissions if ... the underwriting commissions are applied for the purposes of the schemes and would, but for this subsection, be chargeable to tax under Case VI of Schedule D.’

- (ii) Stage 1 — on whether the sub-underwriting contracts entered into *unequivocally* bear the legal character of a trade ie, do they unequivocally involve operations of a commercial character which the trustees provide to underwriters (the customer) for reward a service and were they frequent and organised as well as extensive, business-like and for profit; and
- (iii) Stage 2 — if the position at stage one is not unequivocal, then it depends on (a) the particular context in which the activity is carried on, (b) the relationship between the sub-underwriting and the trustees’ investment activity and (c) the trustees’ purpose or motive in

carrying on the sub-underwriting activity.

It is worth while examining these three propositions.

Section 592(3) does not provide a more lenient test for what constitutes trading

The Commissioners rejected as the starting-point the Royal Commission on the Taxation of Profits and Income (1955) Cmnd 9414 which sets out the badges of trade⁵ for analysis of trade and investment. They also considered that the vast majority of leading cases on what constitutes trade were of little assistance. In their view both addressed acquisition and disposal of assets rather than the provision of services.

The Special Commissioners accepted the trustees' counsel's (Michael Flesch QC) contention that the commissions, if earned by non-trustees, would constitute the profits of trade of sub-underwriting and fall to be chargeable to tax under Case I. Commissions earned by trustees of a tax-exempt pension scheme who did not normally engage in trade, on the other hand, do not fall to be taxed because they were given a safe harbour in s. 592(3). This requires s. 592(3) to be construed 'purposively' to import a lenient test for whether trustees are trading.

Paragraph 73 of the Commissioners' decision states that:

'Mr Flesch argued that the intention of section 592(3) was to exempt underwriting commissions received by a tax exempt approved scheme as part of its normal investment activity but to tax those unusual cases where commissions were received in the course of trade. Trading could occur, for example:

— where the underwriter wanted the commission and not the shares

- where there was an intention to sell the underwritten shares and not to hold them as long-term investments
- where there was a considerable degree of selectivity as to which shares to underwrite
- where there was a business structure with employees specifically engaged to carry out the underwriting activity; and
- where the commissions were brought into a profit and loss account.'

In his skeleton argument on the appeal to the High Court, Mr Flesch QC put it even more starkly:

'Section 592(3) should be construed purposively: see *IRC v. McGuckian* [1997] STC 908 especially at pp 915c–916h and at 920e–h. It cannot have been Parliament's intention to restrict relief to cases where Pension Funds only undertook very occasional underwriting. For large Pension Funds the relief would become meaningless.'

The Commissioners clearly accepted this argument. At paragraph 93 they stated that:

'93. We are not considering an abstract situation but actual transactions in respect of exempt approved schemes for which Parliament has made specific provision in section 592(3). If the very nature of sub-underwriting meant that it was trading section 592(3) would be devoid of meaning. The Taxes Act is a consolidated Act which must be construed as a whole. ... The logic is therefore that underwriting by exempt approved schemes is not necessarily trading. Mr Brennan [counsel for the Revenue] accepted this but said that it was trading unless carried out on isolated occasions and not on a habitual, organised, extensive or business-like basis. The difficulty with this approach is that pension fund trustees and their managers are under a duty to be organised and business-like and that sub-underwriting will not be offered unless they are likely to accept it. This approach, therefore, while paying lip-service to the efficacy of section 592(3) in effect negates it.'

Lightman J did not accept the argument that there is a safe harbour ie, a lenient test for trading in section 592(3). He held that:

‘The criterion as to what does or does not constitute “profits of trade” is the same in all cases wherever this question arises. There is no predisposition in favour of holding that the profits earned by the trustees of exempt schemes do not fall within Case I; and there is no special meaning to be given to the word “trade” where the activity in question has been carried on by trustees of exempt schemes. The premise on which section 592 is based is that, depending on all the circumstances, receipt of profits from sub-underwriting by trustees of exempt schemes (as by anyone else) may fall within Case I or Case VI. The same test is to be applied in the case of trustees of exempt schemes as in the case of anyone else. The fact that the answer to that question decides whether there is entitlement to an exemption under section 592(3) is irrelevant in deciding what the answer is.’

When do sub-underwriting contracts unequivocally bear the legal character of a trade?

Lightman J held that the contracts for the BT and Post Office funds entered into by the Trustees did. He reached this conclusion because:

‘In my judgement the activity (in the language of Lord Reid) involved operations of a commercial character by which the Trustees provided to customers (namely the lead underwriters) for reward a service, namely sub-underwriting; and (in the language of Lord Wilberforce) involved over a period of years the exchange of services for reward and was frequent (or habitual) and organised as well as extensive, business-like and for profit. In short, viewed objectively the activity has all the hallmarks of a trade.’

The Commissioners reached a contrary conclusion by not adopting Lightman J’s test for trading. The Commissioners did not reach a different view of the evidence from Lightman J on the frequency and length of the sub-underwriting contracts, nor did they disagree that they were habitual and organised.

However, they did not accept that these characteristics determined whether the trustees were trading.⁶ They reasoned that:

‘91. The lack of precision in the opinions of two of the most distinguished Law Lords of recent years shows how elusive the concept of trade is. Lord Reid spoke of “a variety of meanings”, “sometimes” and “commonly”. Lord Wilberforce spoke of “cannot be precisely defined”, “normally” and “sometimes a matter of degree”. ... What is clear is that the question whether an activity amounts to a trade must be determined in the light of the facts and circumstances of the particular case and is often, as it is here, a matter of degree.

‘Bearing in mind the provisions of section 592(3) we consider that the subject-matter, frequency, organisation and the extent of the transactions were not determinative. The answer depends on the nature of the [Trustees’] activities and their motive.

‘100 ... the subject matter of the transactions, their frequency, length and the fact that they were habitual and organised do not determine whether they were trading. They are all features which are characteristic of sub-underwriting in respect of exempt approved schemes. In our judgement the crucial factor is the motive viewed not only subjectively but also objectively in the light of the surrounding circumstances.’⁷

The Commissioners found the following factors in the surrounding circumstances more persuasive:

— the relative small scale of the sub-underwriting transactions

compared to overall equity transactions — in the sample year of assessment 1992/93 gross sub-underwriting commission received by BTPS was £809,000 (out of 68 sub-underwriting transactions), which represented 0.2386 per cent of total equity return and 0.1293 per cent of total investment return of £653m (from 5,500 investment transactions). In the seven years to March 1994, the highest commission percentage was 0.3403 per cent (1990) of the total investment return;

- the frequency arose from an index-tracking investment strategy — in the larger two schemes the core portfolio was predominantly index-tracking;
- the length of the sub-underwriting transaction was governed by the terms of the issue over which the Trustees had no control; and
- the sub-underwriting was not a separate profit centre and was not treated as such in the fund accounts.

Lightman J has, as has been noted, a two-stage test for determining whether an activity amounts to trading.⁸ In his two-stage test he does not allow motive to feature in stage one.⁹ Only Lord Reid's and Lord Wilberforce's criteria¹⁰ figure in stage one and if the answer is unequivocal then stage two of the examination process (in which he will permit motive to be considered) is not reached.

In short, Lightman J held that the Commissioners erred, first by taking a purposive approach to the construction s. 592(3) (see 7.3 above) and, secondly, in not restricting themselves to the limited criteria permitted in his stage one of the two-stage test.

The Commissioners also employed a separate line of reasoning. They concluded that the transactions were an

essential part of the investment process and were integral to, ancillary to and took their colour from, the investment process. The Commissioners found it relevant that:

- the sub-underwriting was undertaken purely within the context of holding shares for the purposes of the Trustees' schemes (ie, it was consistent with the BTPS's strategy of index-tracking);
- the shares if taken up in the stick were held long term;
- sub-underwriting of smaller companies in which the schemes invested was motivated to support the share price.

Lightman J, in response, held that the connection between sub-underwriting and investment was not sufficiently close to come within the authorities cited by the Commissioners¹¹ to support the conclusion that it was an essential part of the investment process and was integral to, ancillary to and took its colour from, the investment process.

Lightman J concluded:

'There can be no doubt that: (1) investment and underwriting are two separate activities; (2) investment activities can be carried on without sub-underwriting: sub-underwriting is not an essential part of investment; (3) the Trustees' investment activities provided opportunities for profitable sub-underwriting and sub-underwriting in turn gave rise to advantageous investment (ie, placing) opportunities and was conducive to the well-being of companies in which investments were made; (4) the two activities could be and were to great advantage carried on together; and (5) the sub-underwriting on its own was assumed to be profitable and would not otherwise have been undertaken. The undoubted fact is that (jointly with their activity in the field of investment) the Trustees (for good commercial reasons) engaged in the separate

and distinct activity of sub-underwriting. This was the commercial reality, which cannot be obliterated or obscured by any different perceptions on the part of the Trustees or the way their business activities are managed or the way the receipts are applied or treated in their accounts.'

What are the tax consequences?

Both the Special Commissioners and the High Court held that the exemption in s. 686(2)(c) did not apply. The Trustees are therefore chargeable under Case I of Schedule D to the additional rate of tax applicable to trusts (34 per cent).

How safe is it to sub-underwrite now?

The decision of Lightman J leaves little room for tax-free sub-underwriting except where it is extremely infrequent. The issue is whether trustees consider the activity justified with 34 per cent less income from it.

Whether tax paid under section 601 Income and Corporation Taxes Act 1988 is recoverable where the underlying transaction was invalid and reversed

The final part of the paper on whether tax is recoverable when paid under section 601 Taxes Act 1988 where the underlying payment is refunded to the trustee will be structured as follows:

- the legislation
- the background facts to the *Hillsdown Holdings plc v. Inland Revenue Commissioners* [1999] STC 561
- the decision.

The legislation

Section 601 imposes a tax charge of 40 per cent of the payment where:

'a payment is made to an employer out of funds which are or have been held for the purposes of' an exempt approved scheme.

Background facts

The main facts were these:

- HF Meat and Foods Processing Pension Scheme Trustees Limited Ltd (*HF Trustee*) is trustee of an approved pension scheme for Hillsdown employees.
- the scheme received a surplus transfer payment on the winding up of the FMC scheme (another scheme for Hillsdown employees);
- the HF scheme then had a substantial surplus and the trustee made two refunds of surplus totalling £19m to Hillsdown in 1989 and 1990;
- tax of £8m (approx.) under section 601 Taxes Act 1988 was paid;
- Knox J (*Hillsdown Holdings plc v. Pensions Ombudsman* [1996] OPLR 291, QBD, [1997] 1 All ER 862) held the transfer payments to be in breach of trust and ordered Hillsdown to return the surplus to HF Trustee;
- the sums distributed net of tax paid have been returned to HF Trustee;
- Hillsdown Holdings plc, and HF Trustee, therefore, sought repayment of the tax of £8m paid to the Revenue.

The Revenue refused on the basis that:

- (i) the primary duty of the Revenue is to collect tax and not to forgive or repay tax;
- (ii) the taxpayer had made no mistake in paying the tax; and
- (iii) no mistake was made by the Revenue and no representations were made or undertakings were given by it that tax would be repaid.

The Revenue argued that the sums were still due as tax even though the transaction was invalid. Mr Glick QC (Revenue's counsel) argued that money had actually moved from the pension fund to the employer. That was the event which he contended gave rise to a tax charge under s. 601. The wording of the section was clear and unambiguous. It applies to any payment and not just to where surplus was being reduced in accordance with schedule 22.

Decision

Arden J held that the Revenue must refund the tax for the following reasons:

- (i) the word 'payment' can have different meanings and therefore the court is entitled to have regard to the context and purpose (see *Ramsay* [1981] STC 174 at 179;
- (ii) there was no reason why Parliament should seek to tax a payment which was not effectively made and indeed the policy of the section was not to suggest otherwise;
- (iii) the construction of s. 601 does not require (or support) the contention that 'payment' catches ineffective payments;
- (iv) s. 601(6)(a) uses the word 'transfer' in relation to a transfer of asset. The provision is not talking about a transfer of legal title. Likewise para 3(3)(a) of Schedule 22 refers to 'making payments to an employer' as a way of reducing statutory surplus. A surplus can not be reduced by a payment which does not have the effect of transferring the equitable interest in the moneys to the employer.
- (v) s. 601(1) uses the words 'out of' the fund. Arden J concluded that 'these words indicate that payment must result in funds effectively leaving the

fund as intended by the transaction (whether absolutely or for a period, as in the case of a loan) ...

Likewise, under 601, the payment must be made "to an employer" and this must mean in the employer's capacity as such and exclude the case where the employer merely receives the moneys as a trustee under a trust arising under operation of law for the fund.'

Arden J held that, had she not reached the above conclusions on the construction of s. 601, she would not have held that the tax was repayable for mistake. The only mistake was by the trustee as to extent of the transfer power and whether the assets could remain in the scheme.

© Dan Schaffer

References

- 1 For further details see para 31–39 of the decision of the Special Commissioners *Clarke (Inspector of Taxes) v. Trustees of the British Telecom Pension Scheme and others* [1998] All ER 453.
- 2 See generally *The Tax Journal*, 5th August, 1993 and 16th September, 1993.
- 3 Before 1988 similar provisions were contained in s. 21(2) and (2A) of the Finance Act 1970 as amended by the Finance Act 1971.
- 4 Before 1988 similar provisions were found in s. 16(2)(c) of the Finance Act 1973.
- 5 (a) *Subject of transaction*
If an asset does not produce income or cannot be enjoyed personally, it is not likely to be investment so far as pension trustees are concerned, but instead something capable of being traded in.
- (b) *Length of ownership*
If an asset is sold soon after its acquisition, it is more likely to be considered trading unless between the asset's purchase and sale, circumstances had changed substantially.
- (c) *Frequency of transactions*
Single transaction unlikely to be regarded as trading, but repeated transaction of the same type could indicate trading taking place.
- (d) *Work on the asset realised*
Suggests trading.
- (e) *Circumstances responsible for the sale*
Must be a good reason for the sale.

- (f) *Motive*
Motive in selling the asset.
- 6 See paragraph 100.
- 7 See paragraph 100.
- 8 'The first stage is to concentrate on the relevant activity of the Trustees in entering into the sub-underwriting contracts and consider whether, viewed objectively, that activity bears the legal character of a trade. If viewed objectively the activity clearly and unequivocally bears the legal character of a trade, that is the end of the matter. If however viewed objectively the legal character of the activities is equivocal, it is appropriate to proceed to a second stage. At this second stage it is appropriate to consider how far further light is cast on the activity and how far its legal character is affected by particular facts of this case, as it might be expressed, the particular context in which the activity is carried on and most particularly, the relationship of this activity with the Trustees' investment activity and the Trustees' purpose or motive in carrying on the sub-underwriting activity.'
- 9 In this context he held that the trustees' motive was legally irrelevant.
- 10 Lightman J cites Lord Reid in *Ransom v. Higgs* (1971) 50 STC 1 at p78:
- 'As an ordinary word in the English language "trade" has or has had a variety of meanings or shades of meaning. Leaving aside obsolete or usage, it is sometimes used to denote any mercantile operation, but it is commonly used to denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or services.'
- Lord Wilberforce said at page 88:
- '"Trade" cannot be precisely defined, but certain characteristics can be identified which trade normally has. ... Sometimes the question whether an activity is found to be a trade becomes a matter of degree, of frequency, or organisation, even of intention and in such cases it is for the factfinding body to decide on the evidence whether a line is passed ... Trade involves, normally, the exchange of goods or of services for reward ... there must be something which the trade offers to provide by way of business.'
- The Commissioners consider that these two definitions are of little assistance because of their lack of precision.
- 11 *Imperial Tobacco Co (of Great Britain and Ireland) Ltd v. Kelly* 25 TC 292 and *Davies v. The Shell Company of China Ltd* 32 TC 133.