Vermilion Holdings: how a deeming provision works in the context of employment-related securities

Employment Tax

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We examine how the Supreme Court decided a deeming provision operated in the context of the employment-related securities rules.

Key Points

What is the issue?

The employment-related securities rules provide a prescriptive code governing the taxation of shares, securities and similar in an employment context. The rules are found in Part 7 of ITEPA 2003, with 14 chapters concerning different scenarios.

What does it mean to me?

It can be difficult to determine whether, on the particular facts of any case, the right or opportunity to acquire an option is made available by reason of an individual's employment.

What can I take away?

Deeming provisions effectively pretend that X is Y. Therefore, if a scenario applies only if one is in situation Y, a deeming provision can ensure that the scenario also arises if one is in situation X. However, there can be some limits.

The employment-related securities rules caused a lot of controversy when they were first announced in April 2003, just a few days after the Income Tax (Earnings and Pensions) Act (ITEPA) 2003, containing the previous version of the rules, came into force. They provide a prescriptive code governing the taxation of shares, securities and similar in an employment context.

The rules are found in Part 7 of ITEPA 2003, with 14 chapters concerning different scenarios. The Supreme Court has recently considered the rules in Chapter 5, which deals with employment-related share options, in the case of *HMRC v Vermilion Holdings Ltd* [2023] UKSC 37.

The facts of the case

At the heart of the case was a business adviser and investor, Mr Noble, who in 2006 invested in Vermilion Holdings Ltd (Vermilion). As part of the investment process, Vermilion issued Mr Noble (through his company) an option over shares in Vermilion. During the course of 2006, however, Vermilion's business was underperforming and this led to an emergency restructuring, involving the effective dilution of existing investors' interests in the company and the appointment of Mr Noble as Vermilion's executive chairman.

Although the original proposal was for a reduction of the rights from the 2006 option, in the end a clean slate approach was adopted and a new option was granted in 2007, at which point the 2006 option lapsed.

Nine years later, Vermilion was sold, with Mr Noble exercising his option (i.e. the 2007 option) shortly beforehand. That gave rise to a gain in excess of £600,000, which Mr Noble considered to be subject to capital gains tax. HMRC argued, however, that the gain was employment income (under the rules in Chapter 5) and therefore should have been subject to the PAYE provisions. Accordingly, HMRC issued a determination under regulation 80 of the PAYE regulations (SI 2003/2682), demanding that the PAYE that should have been deducted (approximately £285,000) be paid by Vermilion.

The dispute between the parties

The dispute between the parties focused on the single question as to whether the option fell within the scope of Chapter 5. That itself turns on the provisions in ITEPA 2003 s 471. Section 471(1) provides that the Chapter applies if 'the right or opportunity to acquire the securities option is available by reason of an employment of that person or any other person'.

It was common ground that the issue is ultimately a question of fact. What is the reason that led to the option being made available: was it because of someone's employment?

However, sub-section (1) is supplemented by sub-section (3), which is a deeming provision. Sub-section (3) is made up of two parts. The first part provides the general rule:

'A right or opportunity to acquire a securities option made available by a person's employer, or a person connected with a person's employer, is to be regarded for the purposes of sub-section (1) as available by reason of an employment of that person…'

The second part of the deeming provision is an exception which applies if:

a) the person who makes the right or opportunity available is an individual; and

b) that right or opportunity is made available in the normal course of that person's domestic, family or personal relationships of that person.

This wording is similar to a number of provisions in the benefits code and ensures, for example, that a married couple does not unwittingly face a car benefit charge simply because one spouse employs the other in a business and also provides a car to the spouse in the course of normal family arrangements.

Deeming provisions effectively pretend that X is Y. Therefore, if a scenario applies only if one is in situation Y, a deeming provision can ensure that the scenario also arises if one is in situation X. However, there can be some

limits on what is sometimes known as the fiction created by a deeming provision.

The apparent purpose of the deeming provision in sub-section (3) is to provide a rule that deems the existence of an actual employment relationship to be determinative of the question posed by sub-section (1) (except in cases covered by the proviso found at the end of the sub-section). However, the question as to whether that was the correct approach to take to sub-section (3) was the focus of the arguments as this case progressed through the tribunals and the courts.

In the First-tier Tribunal (and later in the Court of Session, by a majority), it was held that the circumstances of the acquisition of the 2007 option were such that the deeming provision was considered not to be applicable. The Upper Tribunal had disagreed with the First-tier Tribunal. As HMRC lost in the Court of Session, it was their appeal which was heard by the Supreme Court.

The Supreme Court's decision

The single judgment was given by Lord Hodge, with whom Lords Lloyd-Jones, Leggatt and Burrows and Lady Rose agreed. He endorsed a five-step approach to deeming provisions:

1. 'The extent of the fiction created by a deeming provision is primarily a matter of construction of the statute in which it appears.
2. 'For that purpose the court should ascertain, if it can, the purposes for which and the persons between whom the statutory fiction is to be resorted to, and then apply the deeming provision that far, but not where it would produce effects clearly outside those purposes.
3. 'But those purposes may be difficult to ascertain, and Parliament may not find it easy to prescribe with precision the intended limits of the artificial assumption which the deeming provision requires to be made.
4. 'A deeming provision should not be applied so far as to produce unjust, absurd or anomalous results, unless the court is compelled to do so by clear language.
5. 'But the court should not shrink from applying the fiction created by the deeming provision to the consequences which would inevitably flow from the fiction being real.'

With those principles in mind, Lord Hodge then proceeded to ascertain the purpose of the deeming provision in s 471(3). He considered that not to be particularly difficult.

As the *Vermilion* case itself had demonstrated, it can be difficult to determine whether, on the particular facts of any case, the right or opportunity to acquire an option is made available by reason of an individual's employment – the alternative possibility being that it was provided for another reason and irrespective of the fact of the parallel employment.

Lord Hodge considered that sub?section (3) was intended to cut across this difficult factual enquiry and provide a definitive answer, being that the fact of an employment is in most cases conclusive. Indeed, the carve out for family relationships (where, factually, it will often be clear that something is being provided for reasons other than the employment) emphasises the broad nature of the deeming provision.

The First-tier Tribunal and the majority in the Court of Session had erred by trying to reverse engineer the scope of the deeming provision by deciding whether, as a matter of policy, this was the kind of arrangement that ought to be caught by the rules in Chapter 5.

Commentary

I must admit that I was somewhat surprised when I read the First-tier Tribunal's decision. Although I could fully understand that this was the kind of commercial arrangement that, when looking at the circumstances in the round, could be said to fall beyond the target of the rules in Chapter 5, the deeming provision seemed to be unavoidable.

I admired the First-tier Tribunal's ingenuity but was unsure how it could be justified from the perspective of the legislation. The Supreme Court's decision reassures me that my instinctive reaction was not misplaced.

One of the arguments relied upon by Vermilion was how the broader interpretation of the deeming provision could affect other commercial scenarios. For example, the Supreme Court was asked to consider the situation where a bank offered its customers a securities option. In the situation where the customer was also an employee of the bank, the broad reading of the deeming provision would mean that the two classes of customer (employees and non-employees of the bank) would be taxed differently. That is clearly a somewhat surprising outcome but the case law (confirmed in *Vermilion*) confirms that this is what the legislation means – perhaps with the unfairness in some cases being a price to pay for the relative simplicity that the deeming provision provides.

Of course, Parliament can consider whether, going forward, it wishes to relieve individuals in Mr Noble's position (or the position of the hypothetical employees of the bank) from the tax rates applicable to employment income and subject their gains only to capital gains tax. To be honest, however, I do not expect these rules to change any time soon (at least in this regard).

However, I have long been conscious of a similar rule governing the provision of accommodation by employers. Section 97(2) of ITEPA 2003 contains a deeming provision which is materially identical to that in s 471(3), with a similar carve-out for personal relationships in cases where the employer is an individual. However, s 98 then provides a further exception. It exempts from the rules situations where the employer is a local authority and the employee is provided with accommodation by the local authority on terms that are no more favourable than would be offered to non-employees. In other words, occupants of council housing should not be subjected to a tax charge simply because they are employed by the council that owns their home.

It is hard to see any policy objection to that additional exception and I would be surprised if it were ever to be repealed. But given that so much social housing is now provided by housing associations, rather than the councils direct, I have long wondered why there is not a similar carve-out for employees of housing associations. Perhaps that is an area where legislative reform is not only overdue but might be less controversial.

What to do next

It must be remembered that one of the arguments being advanced on behalf of Vermilion was that the 2007 option was, in effect, a restatement (with reduced rights) of the 2006 option, which fell outside the scope of Chapter 5. Indeed it was a late change of plan to prepare a new option agreement rather than modify the existing option.

However, this is simply a more attractive way of saying, ‘Please don’t tax me on my transaction because I could have entered into it in a more tax efficient way.’ As a general rule, taxpayers will be taxed by reference to the facts as they are and not how they might have been.