

Case No: 2002/0793

Neutral Citation Number:[2002] EWCA Civ 1829
IN THE SUPREME COURT OF JUDICATURE
COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
(MR JUSTICE LIGHTMAN)

Royal Courts of Justice
Strand,
London, WC2A 2LL

Thursday 12 December 2002

Before:

LORD JUSTICE KENNEDY
LORD JUSTICE CHADWICK
and
LORD JUSTICE JONATHAN PARKER

MANSWORTH (HMIT)

Appellant

and

JELLEY

Respondent

Mr T Brennan QC and Mr H McKay (instructed by the Solicitor of Inland Revenue for the Appellant)

Mr M Sherry and Miss L Rippon (instructed by Messrs B P Collins, Gerrards Cross for the Respondent)

Lord Justice Chadwick :

1. This is an appeal from an order made on 20 March 2002 by Mr Justice Lightman on an appeal under section 56A of the Taxes Management Act 1970 from a decision of the Special Commissioners (Mr Theodore Wallace) dated 5 November 2001 allowing an appeal by the taxpayer, Mr Colin Jelley, from assessments to capital gains tax on the disposal of shares which he had acquired by the exercise of stock options granted to him by his employer, J P Morgan & Co Incorporated. The issue raised by the appeal is upon what basis the cost to the taxpayer of acquiring those shares is to be ascertained for the purposes of computing the gain on disposal.

The underlying facts

2. The underlying facts are set out in paragraphs 5 and 6 of the special commissioner's decision:

“5. The Appellant was non-resident in the eight fiscal years up to 1987/88. While abroad he worked for subsidiaries of J P Morgan & Co Inc and was granted options over shares in that company exercisable at specified prices, in effect at their market value on the New York Stock Exchange at the time of the grant.

6. The options in question were granted in 1983, 1984 and 1985. The 1983 option was for 3600 shares at [\$20.244]¹ and that for 1984 was for 4000 shares at \$17.938. Both were exercised in June 1989 at a combined cost of \$144,630 and the shares were sold a week later for \$313,500. The 1985 option (after a bonus adjustment) was for 4400 shares at \$24.094. It was exercised in April 1991 and the shares were sold [on the same day] at a profit of \$120,578.”

3. It may be noted (i) that it has not been suggested that the scheme under which the options were granted in this case was an approved share option scheme within the meaning of section 185 of the Income and Corporation Taxes Act 1988 (first enacted as section 47 of the Finance Act 1980), (ii) that, but for the fact that the taxpayer was non-resident at the time that the options were granted, he would have been chargeable to income tax under schedule E on an amount equal to the amount of his gain computed in accordance with section 135(3) of the Taxes Act 1988 – see sections 135(1) and 140(1)(a) of that Act (the provisions of which were formerly in sections 186(1) and (9) of the Income and Corporation Taxes Act 1970) - and (iii) that, if he had been chargeable to tax under section 135(1) of the Taxes Act 1988, an amount equal to the amount of the gain chargeable to tax under that section would have been brought into account as part of the acquisition cost for the purposes of the charge to capital gains tax – see section 32A of the Capital Gains Tax Act 1979 (now re-enacted as section 120 of the Taxation of Chargeable Gains Act 1992). The particular feature which gives rise to the issue raised by this appeal is the change from non-resident to resident status between the dates upon which the options were granted and the dates upon which they were exercised.

¹ The figure shown in the decision (\$200.244) is plainly an error.

The assessments

4. The taxpayer was assessed to capital gains tax for the years ending 5 April 1990 and 5 April 1992 on the gains made on the disposals of the option shares. The relevant assessments are dated 9 March 1992 and 19 April 1996. The assessments were made under the provisions of the Capital Gains Tax Act 1979. The basis of the assessments, as the special commissioner pointed out, was that “the base value for capital gains tax purposes consisted of the sum of price paid for the shares on exercise of the options and the market value of the options when originally granted, which was treated as nil”. This was said to be the basis required by section 137(3) of the 1979 Act when read in conjunction with section 29A(1) (now re-enacted as sections 144 (3) and 17(1) of the Taxation of Chargeable Gains Act 1992).

5. The two sections are in these terms (so far as material):

“137(3) The exercise of an option by the person for the time being entitled to exercise it shall not constitute the disposal of an asset by that person, but, if an option is exercised then the acquisition of the option (whether directly from the grantor or not) and the transaction entered into by the person exercising the option in exercise of his rights under the option shall be treated as a single transaction and accordingly –

(a) if the option binds the grantor to sell [a call option], the cost of acquiring the option shall be part of the cost of acquiring what is sold, and

(b) if the option binds the grantor to buy [a put option], the cost of the option shall be treated as a cost incidental to the disposal of what is bought by the grantor of the option.”

“29A(1) Subject to the provisions of this Act, a person’s acquisition or disposal of an asset shall for the purposes of this Act be deemed to be for a consideration equal to the market value of the asset –

(a) where he acquires or, as the case may be, disposes of the asset otherwise than by way of a bargain made at arm’s length, . . . , or

(b) where he acquires or, as the case may be, disposes of the asset wholly or partly for a consideration that cannot be valued, or in connection with his own or another’s loss of office or employment or diminution of emoluments, or otherwise in consideration for or recognition of his or another’s services or past services in any office or employment or of any other service rendered or to be rendered by him or another.”

6. On the basis that the options had been acquired (as the special commissioner found) “otherwise than by way of bargain made at arm’s length” or (as the judge was later to

describe as common ground) “by reason of [the taxpayer’s] employment”, the revenue took the view that section 29A(1) of the 1979 Act required the cost of acquiring the options to be deemed – for the purposes (*inter alia*) of section 137(3)(a) of that Act – to be equal to the market value of the options at the time of acquisition; and (if that market value were to be taken as nil) the cost of acquiring the shares on the exercise of the option was – and could only be – the price payable under the option.

The taxpayer’s appeal to the special commissioner

7. The taxpayer challenged the assessments on the basis that the revenue’s approach failed to give proper effect to the requirement, imposed by section 137(3) of the 1979 Act, that “the acquisition of the option . . . and the transaction entered into by the person exercising the option in the exercise of his rights under the option shall be treated as a single transaction”. It was said that the “single transaction” was the acquisition of the option shares by the acquisition and exercise of the rights under the option. Once the option had been exercised, the effect of section 137(3) of the 1979 Act was that the only “asset” acquired, for the purpose of capital gains tax, was the option shares. The option itself could no longer be treated as being a separate asset. In particular, the option itself had to be treated as if it were not an asset capable of being acquired or disposed of for the purpose of the charge to tax; and so not an asset in relation to the acquisition or disposal of which section 29A(1) of the 1979 Act could have any application. The only asset to which section 29A(1) was capable of having any application was the option shares.
8. In those circumstances, it was said, the only relevant question was whether or not – treating the acquisition of the option shares by the acquisition and exercise of the option as a single transaction (as section 137(3) of the Act required) – the acquisition of those shares was “otherwise than by way of bargain made at arm’s length” or “otherwise in consideration for or recognition of his . . . services . . . in any employment”. Given that the answer to that question was plainly “yes”, section 29A(1) of the 1979 Act required that the option shares be treated as acquired for their market value.
9. If the true effect of sections 137(3) and 29A(1) of the 1979 Act, read together, is that the option shares must be treated as acquired for their market value, then it has not been in dispute that the time at which market value is to be ascertained is the time at which that acquisition was made. Nor has it been in dispute that the time at which that acquisition was made was the time when the option was exercised. That was the effect of section 27(2) of the 1979 Act (now section 28(2) of the 1992 Act). In the circumstances that the taxpayer disposed of the option shares on the same day as he acquired them – or, in the case of the 1989 acquisition, within a few days of acquiring them – there was no gain upon which he could be assessed to tax.
10. The special commissioner reminded himself that the amount of the gains accruing on a disposal of assets fell to be computed in accordance with Chapter II of the 1979 Act, of which section 29A forms part. Section 32(1) of the Act required that, except as otherwise expressly provided, the sums allowable as a deduction in the computation of the gain accruing to a person on the disposal of an asset should be restricted to (a) the amount or value of the consideration, in money or money’s worth, given by him or on his behalf wholly and exclusively for the acquisition of the assets, together with the incidental costs,

(b) the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing its value, and (c) the incidental costs to him of making the disposal. Section 32(2) prescribed what could be treated as incidental costs in that context. The special commissioner pointed out that, in a case to which section 29A(1) of the 1979 Act had no application, the effect of section 137(3), read with section 27(2) of the Act, was that the acquisition cost, for the purposes of section 32(1), would be “the option money plus the striking price with any incidental costs under section 32(2)”. As he said “the price payable on exercise would be deductible under section 32(1) and the cost of the option would be part of the acquisition cost by reason of section 137(3)”.

11. The special commissioner went on to consider whether section 29A of the 1979 Act had application to the facts in the appeal before him; and, if so, to what effect. At paragraph 30 of his decision he said this:

“It is clear that section 29A(1)(b) applied to the acquisition of the options. That does not however answer the acquisition of the shares.”

It is, I think, clear that the special commissioner took the view that the question on which the issue turned was whether the acquisition of the shares – treating the acquisition and exercise of the option as a single transaction (as section 137(3) of the Act required) – was an acquisition “otherwise than by way of a bargain made at arm’s length” and so within section 29A(1)(a). He rehearsed the rival arguments advanced in relation to that question; and explained why he preferred that of the taxpayer. He said this, at paragraph 33 of his decision:

“Much of the difficulty arises because of the opaque wording of section 29A(1)(a). In plain English, an acquisition was treated as being at market value when it was not by way of bargain at arm’s length. I have already concluded that on exercise of the options the question whether the acquisition of the shares was ‘by way of bargain at arm’s length’ turns on whether the option was acquired at arm’s length. Mr Brennan [on behalf of the revenue] did not suggest that the grant of the options was by bargain at arm’s length. It was not part of the Appellant’s terms of employment but an additional incentive. Paragraph 4 of the option agreement expressly excluded the grant of the option from being evidence of any agreement by the company to continue to employ the Appellant. Nor did it involve any undertaking by him to continue in service.”

He allowed the appeal.

The revenue’s appeal to the High Court

12. The revenue appealed to the High Court on the ground that the special commissioner had misinterpreted sections 29A and 137 of the 1979 Act. It was said that he should have held that the acquisition cost of the shares was the sum of the market value of the option and the exercise price. The appeal came before Mr Justice Lightman.

13. At paragraph [8] of his judgment ([2002] EWHC 442 (Ch), [2002] STC 1013, 1017) the judge summarised the statutory scheme in terms which I do not understand to be controversial:

“The statutory scheme appears to be as follows: (a) except where otherwise provided and accordingly except where otherwise provided by s 29A(1)(a) or (b), the sums allowable as a deduction from the consideration received in the computation for capital gains tax purposes of the gain accruing to a person on the disposal of an asset are restricted to the amount or value of the consideration in money or money’s worth given for the acquisition of the asset, the amount of expenditure on the asset and the incidental costs of making the disposal (see s 32). Where s 29A(1)(a) or (b) applies, the acquisition cost is deemed to be a consideration equal to the market value of the asset; (b) accordingly the ordinary rule allowing the amount or value of the actual consideration is displaced in favour of allowing instead the market value by s 29A(1)(a) where the acquisition of the asset is ‘otherwise than by way of a bargain made at arm’s length’ and by s 29A(1)(b) where the acquisition is by reason of employment; (c) a distinction is drawn between the acquisition of an option and any subsequent acquisition of the underlying asset pursuant to the exercise of that option and the respective timings of the two acquisitions; (d) the acquisition of an option is the acquisition of an asset and the acquisition takes place at the time of the contract for the grant of the option (see ss 27(1) and 137(1), (2) and (3)); (e) for capital gains tax purposes the acquisition cost of the option is the actual cost or (when s 29A(1)(a) or (b) applies) the market value of the option at the date of the acquisition of the option; (f) s 137(3) lays down the principles to be applied where, following the grant of an option, the option is exercised. The acquisition of the option and the subsequent acquisition of the underlying asset are to be treated as single transaction. For this purpose the acquisition of the option is to be treated ‘as part of a larger transaction’ (see the language of the final words of s 137(1)), namely the acquisition of the underlying asset. The time of the acquisition of the underlying asset is the time of the exercise of the option (see s 27(2)). As the acquisition of the option is to be treated as part of this acquisition, ‘accordingly’ the cost of acquiring the option is to be treated as part of the cost of acquiring the underlying asset (see s 137(3)(a))”

14. The judge recorded that it was common ground that the taxpayer acquired the options by reason of his employment and that therefore s 29A(1)(b) applied to those acquisitions. He pointed out that the special commissioner had held that the options were granted ‘otherwise than by way of bargain at arm’s length’; and that the revenue had accepted that that finding of fact could not be challenged. He identified what he described as “the critical issue” in these terms – at paragraph [10] of his judgment ([2002] STC 1013, 1018):

“The critical issue before the commissioner and on this appeal before me is the impact (if any) of the fact that the taxpayer acquired the options by reason of his employment [and] ‘otherwise than by way of bargain made at arm’s length’ upon the character of the acquisition of

the underlying assets acquired on the exercise of the options, namely the shares, and whether by reason of these facts for the purposes of s 29A(1)(a) and (b), not merely the options, but the shares themselves are to be treated as acquired by reason of his employment and ‘otherwise than by way of bargain made at arm’s length.’ ”

15. He resolved that issue at paragraph [14] of his judgment ([2002] STC 1013, 1018-1019):

“In my view, where there has been (as there has been in this case) the grants of options to purchase shares followed (pursuant to the exercise of the options) by acquisitions of the shares, s 29A focuses on the entirety of the process of the acquisition of the shares (in accordance with section 137(3)) treating the two stages (of acquisition of the options and the exercise of the options) as single transactions. Accordingly when determining in such a case whether the acquisition of the shares falls within s 29A(1)(a) or (b), the character of the grant of the option will be of critical importance. If an option is granted by way of bargain at arm’s length, the acquisition pursuant to exercise of the option must also (at least in any ordinary case) constitute a like bargain and fall outside s 29A(1)(a); and if the grant of an option is otherwise than by reason of the grantee’s employment, so in any ordinary case the acquisition pursuant to that option will also (at least in any ordinary case) constitute a like bargain outside s 29A(1)(b). But if the option is a gift or contains the elements of a gift or is otherwise other than a bargain at arm’s length or is granted by reason of the grantee’s employment, so must also (at least in any ordinary case) any acquisition pursuant to exercise of that option.”

16. On the basis of that analysis – and on the basis that (as he held) “no one could fairly and sensibly regard the taxpayer’s acquisition of the shares (looked at as a whole) as an acquisition by way of bargain at arm’s length” and “the taxpayer’s acquisition of the shares (again looked at as a whole) was at least in part by reason of the taxpayer’s employment” – the judge held that “in the computation of the cost of the acquisition, the cost of acquisition of the shares must be a consideration equal to the market value at the date of exercise of the options”. Accordingly, he dismissed the revenue’s appeal.

The appeal to this Court

17. The revenue obtained permission to appeal to this Court on the basis that there were questions of general importance on which the guidance of the Court of Appeal was required. It is, perhaps, pertinent to note, however, that the particular issue raised by this appeal is unlikely to be of widespread concern. First, as I have said, the feature which gives rise to that issue is the change from non-resident to resident status between the grant of the options and their exercise. Second, it was suggested to us that, in relation to options granted after 16 March 1993, the provisions of section 149A of the 1992 Act may have the effect that section 17(1) of that Act (which re-enacts section 29A(1) of the 1979 Act) can have no application on the grant of an option to an employee.

18. The principal submission made on behalf of the revenue is that both the special commissioner and the judge were wrong to conclude that the combined effect of sections 29A(1) and 137(3) of the 1979 Act was to deem the acquisition of shares pursuant to an option (where the acquisition of the option itself fell within section 29A(1)) to be an acquisition at the market value of the shares at the time of the exercise of the option. It is pointed out, correctly, that that approach leads to the result that (in a case where the acquisition of the option would otherwise fall within section 29A(1)) the amount of the consideration deemed to be given for the option – that is to say, the market value of the option at the time that it is acquired - is ignored. This, it is said, fails to give effect to the requirement, in section 137(3)(a) of the Act, that “the cost of the option shall be part of the cost of acquiring what is sold”.
19. That point was answered, to my mind cogently, by the judge at paragraph [15] of his judgment ([2002] STC 1013,1019):

“The answer to this challenge is that under the statutory scheme, depending on whether or not section 29A(1)(a) or (b) applies, the cost of acquisition may be the actual cost or the market value. Section 137(3) spells out the two component elements when the actual cost is relevant: i.e. the actual cost both of the option and (under the option) of the underlying asset. Neither is relevant when section 29A(1) applies and the total deemed consideration (or cost) is the market value.”

In recognition, however, of the arguments addressed to this Court, I will explain in my own words why I am satisfied that both the special commissioner and the judge were correct to reach the conclusion which they did.

The capital gains tax legislation

20. Capital gains tax was introduced by Part III of the Finance Act 1965 as a tax on chargeable gains accruing to a person on the disposal of assets – see section 19 of that Act. Section 19 of the 1965 Act, and the principal charging provision, section 20, have been re-enacted in the same, or substantially the same, terms in the 1979 and 1992 Acts (as sections 1 and 2 in each of those later Acts). Section 22(1) of the 1965 Act provided that all forms of property should be assets for the purposes of Part III, including, in particular, options and other incorporeal property – see section 22(1)(a) of that Act. That provision has been re-enacted in the successor Acts – see section 19(1) of the 1979 Act and section 21 of the 1992 Act. Section 22(4) of the 1965 Act contained the provisions, subsequently re-enacted² as section 29A(1) of the 1979 Act, that – by way of exception to the general rule – an acquisition or disposal of an asset should be deemed to be for a consideration equal to the market value of the asset where the acquisition or disposal is otherwise than by way of bargain at arm’s length or at a consideration that cannot be valued or by reason of employment or other service.

² Section 22(4) of the 1965 Act was first re-enacted as section 19(3) of the 1979 Act; but that section ceased to have effect and was superseded by section 29A on the enactment of the Finance Act 1981 – see section 90(1) and (3) of the 1981 Act.

The special treatment of options

21. Options, like most other forms of incorporeal property, are capable of being disposed of by assignment to another; and, where a gain accrues to a person on his disposal of an option, that person will ordinarily be chargeable to capital gains tax. But, it is a particular feature of an option that it will determine upon exercise. It was necessary, therefore, for the capital gains tax legislation to address the question whether the exercise of an option should be treated as a disposal of the asset which section 22(1)(a) of the 1965 Act had declared it to be; and, if so, what should be treated as the consideration for that disposal. That question was resolved by the provisions in paragraph 14 of schedule 7 to the 1965 Act, which were re-enacted as section 137 of the 1979 Act and are now found in section 144 of the 1992 Act. The solution adopted was, in effect, to treat the option as merged in the transaction which results from its exercise.
22. There are, of course, two facets to the question whether the exercise of an option should be treated as a disposal of the asset which section 22(1)(a) of the 1965 Act had declared it to be. The question must be addressed both in relation to the position of the grantor of the option and in relation to the position of the person exercising the option. Paragraphs 14(1) and (2) of schedule 7 to the Finance Act 1965 (sections 137(1) and (2) of the 1979 Act) addressed the position of the grantor; paragraph 14(3) (section 137(3) of the 1979 Act) addressed the position of the person exercising the option.
23. Section 137(1) of the 1979 Act (formerly paragraph 14(1) of schedule 7 to the 1965 Act) provided that the grant of an option should be treated as the disposal of an asset (namely the option) by the grantor; but that provision was expressed to be “subject to the following provisions of this section as to treating the grant of an option as part of a larger transaction”. Section 137(2) of the 1979 Act (formerly paragraph 14(2) of schedule 7 to the 1965 Act) was in these terms:
- “137(2) If an option is exercised the grant of the option and the transaction entered into by the grantor in fulfilling his obligations under the option shall be treated as a single transaction and accordingly –
- (a) if the option binds the grantor to sell, the consideration for the option is part of the consideration for the sale, and
- (b) if the option binds the grantor to buy, the consideration for the option shall be deducted from the cost of acquisition incurred by the grantor in buying in pursuance of his obligations under the option”

The effect of that provision was that, in a case where the option was exercised, the grant of the option was no longer to be treated, for the purposes of capital gains tax, as a disposal of an asset by the grantor. That is recognised by the practice noted in paragraph 12317 (“Exercise of an option”) in the Inland Revenue’s Capital Gains Tax Manual’:

“As a consequence of the option being exercised, the grant of the option ceases to be an occasion of charge. Accordingly any tax charged on the grant needs to be set-off or repaid.”

24. In relation to the grantor, therefore, the position was clear. The position of the person exercising the option was, to my mind, no less clear. The exercise of the option did not constitute a disposal of the option. The opening words of section 137(3) of the 1979 Act so provided. It followed that a person was not subject to a charge for capital gains tax when he exercised the option; as he would have been if, for example, he had disposed of the option by an assignment.
25. I have already set out the provisions of sections 137(2) and (3) of the 1979 Act. Section 137(2) required that “if an option is exercised the grant of the option and the transaction entered into by the person in fulfilment of his obligations under the option shall be treated as a single transaction”. Section 137(3) contained a similar provision: “if an option is exercised then the acquisition of the option . . . and the transaction entered into by the person exercising the option in exercise of his rights under the option shall be treated as a single transaction”. The effect of those provisions was that, in a case where the option was exercised, the grantor (if the option were a call option) or the grantee (if the option were a put option) was treated as having made a single disposal; namely a disposal of the underlying asset in relation to which he had fulfilled his obligations or exercised his rights (as the case might be) under the option. In such a case – that is to say, where the option was exercised - the grant of the option was no longer treated as a disposal of an asset (the option); the only relevant disposal was the disposal of the underlying asset.

The timing of the disposal or acquisition

26. That posed the further question: when did the disposal of the underlying asset take place? Did the disposal of the underlying asset take place at the time that the option was exercised; or when the sale was completed; or did the exercise of the option have the effect that the disposal or acquisition of the underlying asset was to be treated as having taken place at the time of the grant of the option?
27. That was, itself, a facet of the wider question to which Mr Justice Vinelott referred in *Johnson v Edwards (HMIT)* (1981) 54 TC 488, 497G-H:

“Between 1965 and 1971 it was an open question much debated whether a contract for the sale of ascertained property was itself a disposal of the property in cases where the equitable title to the property passed on the making of the contract or subsequently on the date fixed for completion or on the date when the purchase price was paid, albeit that the contract was not actually completed until later.”

That question was resolved by the enactment of section 56(2) of, and paragraph 10 of schedule 10 to, the Finance Act 1971. The provision was re-enacted as section 27 of the 1979 Act. That section provided (so far as material) that:

“27(1) Where an asset is disposed of and acquired under a contract the time at which the disposal and acquisition is made is the time the contract is made (and not, if different, the time at which the asset is conveyed or transferred).

This subsection has effect subject to . . . subsection (2) below.

(2) If the contract is conditional (and in particular if it is conditional on the exercise of an option) the time at which the disposal and acquisition is made is the time when the condition is satisfied.”

The position, therefore, since 1971 (if not before) has been that, in a case where an asset was disposed of in fulfilment of obligations or in exercise of rights (as the case might be) under an option (which are the cases to which sections 137(2) and (3) of the 1979 Act applied), the disposal of the underlying asset took place at the time when the option was exercised. In such a case, it was that disposal – and only that disposal – which gave rise to a charge to tax. And it was to that disposal and the corresponding acquisition – and only to that disposal and acquisition – that the provisions formerly in section 22(4) of the 1965 Act and subsequently re-enacted as section 29A(1) of the 1979 Act could have any application.

The application of the deemed market value rule

28. In determining whether, in such a case, section 29A(1) of the 1979 Act – the deemed market value rule - does have any application to that disposal and acquisition, the question is whether the asset which is the subject of the only relevant disposal and acquisition (the underlying asset) has been disposed of or acquired otherwise than by way of bargain made at arm’s length (section 29A(1)(a)) or at a consideration that cannot be valued or by reason of employment or other service (section 29A(1)(b)). If that question is answered in the affirmative, then section 29A(1) of the 1979 Act, in conjunction with section 27(2) of that Act, requires that the disposal of the underlying asset, or its acquisition, be deemed to be for a consideration equal to its market value at the time of the exercise of the option. If the answer is negative, then section 29A(1) has no application.
29. In a case where section 29A(1) of the 1979 Act had no application the consideration at which the disposal was treated as made depended on whether the disposal was made in fulfilment of obligations under a call option or in exercise of rights under a put option. In the former case, the disposal will have been made by the grantor of the option. The consideration for the sale includes the consideration paid to him for the option – see section 137(2)(a). In the latter case, the disposal will have been made by the grantee of the option. The cost of the option is to be treated as a cost incidental to the disposal and so may be deducted from the consideration under section 32(1)(c) of the Act – see section 137(3)(b). The cost of acquisition is treated in much the same way. Where the underlying asset is acquired by the grantee in the exercise of rights under a call option, the cost of acquiring the option is included as part of the cost of acquiring the underlying asset – see section 137(3)(a). Where the asset is acquired by the grantor in fulfilment of obligations under a put option, the consideration for the option is deducted from cost of acquisition for the purposes of section 32(1)(a) of the Act – see section 137(2)(b).
30. Nothing in the analysis set out in the preceding paragraph casts doubt either upon the proposition that, in cases to which sections 137(2) and (3) of the 1979 Act apply, the only relevant asset in relation to which the acquisition or disposal of which section 29A(1) of that Act can have any application is the underlying asset; or upon the proposition that, in

determining whether, in such a case, section 29A(1) does have any application to the disposal and acquisition of that asset, the question is whether that asset has been disposed of or acquired otherwise than by way of bargain made at arm's length (section 29A(1)(a)) or at a consideration that cannot be valued or by reason of employment or other service (section 29A(1)(b)). Nor, as it seems to me, does that analysis cast doubt upon the proposition that, where that question is answered in the affirmative, then section 29A(1) of the 1979 Act, in conjunction with section 27(2) of that Act, requires that the disposal of the underlying asset, or its acquisition, be deemed to be for a consideration equal to its market value at the time of the exercise of the option. It is necessary to keep in mind that, in a case to which section 29A(1) of the Act does apply, the consideration actually received on the disposal of the asset, or the actual cost of acquiring the asset, is irrelevant. Section 29A(1) deems the consideration on disposal or the cost of acquisition to be equal to the market value of the asset. So, in such a case, it is unnecessary – because irrelevant – to enquire what is the actual consideration or the actual cost.

31. It follows that the judge was right to approach the appeal before him on the basis that the transaction under which the taxpayer had acquired each tranche of shares was a single transaction comprising both the acquisition of the option and its exercise; and that he was right when he identified the question which he had to decide as whether or not that transaction (taken as a whole) was an acquisition otherwise than by way of a bargain made at arm's length or by reason of the taxpayer's employment. And, if that were the right question, there can be no doubt that the judge was correct in the answer which he gave. It is, to my mind, beyond dispute that (taking the transaction as a whole) the acquisition of the shares was an incident of the taxpayer's employment.

32. Mr Brennan QC, who appeared for the revenue in this Court as he had below, sought to persuade us to take a different view. He referred us to the decision of the House of Lords in *Abbott v Philbin* [1960] AC 352. I find it impossible to see how the analysis in that appeal provides any assistance in the present appeal. The question in *Abbott v Philbin* was whether the taxpayer was rightly assessed under Schedule E of the Income tax Act 1952, in the year (1955-56) in which he exercised a share option which had been granted to him by his employer in the previous year (1954-55), on the difference between the option price and the market price of the shares as being a perquisite from his employment. It was accepted that he could have been assessed in the year 1954-55 on the basis that, when granted, the option was a perquisite from his employment; but it was held that the issue of shares on the exercise of the option in a subsequent year could not be a perquisite from employment in that year. As Lord Radcliffe put it, at page 379:

“The advantage which arose by the exercise of the option . . . was not a perquisite or profit from the office during the year of assessment: it was an advantage which accrued to the appellant as the holder of a legal right which he had obtained in an earlier year, and which he exercised as option holder against the company. The quantum of the benefit, which is the alleged taxable receipt, is not in such circumstances the profit of the service: it is the profit of his exploitation of a valuable right.”

In *Abbott v Philbin* the House of Lords, as they were bound to do in the context of a claim to income tax under Schedule E, addressed the questions (i) in which year of assessment did the benefit accrue and (ii) was the benefit a profit or perquisite from service in that year.

That required separate consideration of the grant of the option and its exercise. By contrast, the statutory requirement in the present case – imposed by sections 137(2) and (3) of the 1979 Act – is that the grant (or acquisition) of the option and its exercise be treated as a single transaction.

33. Mr Brennan laid stress on what he described as an anomaly to which the judge's conclusion would lead. He pointed out, correctly, that – in a case where the person for the time being entitled to exercise the option is not the original grantee - the transaction which is to be treated as a single transaction – by virtue of section 137(3) of the 1979 Act – is the combination of the acquisition of the option and the transaction entered into by the person exercising the option in the exercise of his rights under it; not the combination of the grant of the option and the transaction entered into by the grantor in fulfilment of his obligations under it – as would be the case under section 137(2). He invited us to consider the position where an option were granted by A to B, assigned by B to C, and exercised by C against A. In such a case, it is said, the judge's conclusion would lead to the result that the acquisition of the underlying asset by C would be treated as an acquisition at market value if the assignment by B to C of the option were not by way of bargain at arm's length; notwithstanding that the grant of the option by A to B was for full value and not in connection with employment. That may well be so; but it does not seem to me that that would be a surprising or anomalous result. Capital gains tax is a tax on gains which accrue on the disposal of assets. Save, perhaps, in exceptional cases, the person taxed is the person disposing of the asset; and the gain is the gain which accrues to him on that disposal. So, in the example which Mr Brennan invited us to consider, A would be taxed on his disposal of the underlying asset on the basis that the gain which accrued to him was computed by reference to the consideration which he actually received; that is to say, the sum of the consideration for which the option was granted by him to B and the option price paid to him by C on the exercise of the option – see section 137(2)(a). B would be taxed on his disposal of the option to C on the basis that the gain which accrued to him was the difference between the deemed market value of the option when assigned to C and the actual cost of acquisition at the time of the grant. C would not be taxed until he came to dispose of the underlying asset. He would then be taxed on the basis that his cost of acquisition was the market value of the underlying asset at the time when he acquired it from A by exercising his rights under the option – see sections 137(3) and 29A(1)(a). C would be in the same position in that respect as if (absent any option) he had acquired the asset from A otherwise than by way of bargain at arm's length. But that is what the assignment to him of the option by B had enabled him to do. The result which Mr Brennan stigmatised as anomalous seems to me to accord with the general scheme of the capital gains tax legislation.

Conclusion

34. I would dismiss this appeal.

Lord Justice Jonathan Parker:

34. I agree.

Lord Justice Kennedy:

35. I also agree.