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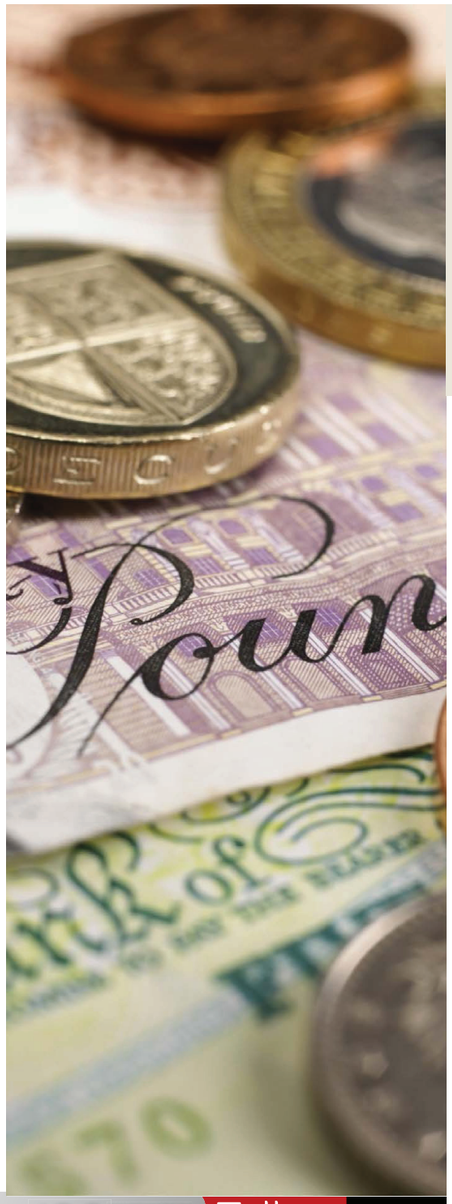

Q&A

Disguised remuneration: where are we now?

Speed read

HMRC has been on the offensive for many years to ensure that all rewards from employment are properly taxed within the income tax and NICs regimes. This year's Finance Bill makes further changes, including the introduction of a new targeted-anti avoidance rule. However, of much greater significance are the changes proposed to be enacted in the Finance Bill 2017, on which HMRC is currently consulting. These measures include: a new tax charge on all existing loans which remain outstanding on 5 April 2019; a new Part 7A gateway for schemes involving close companies; restrictions on the availability of corporation tax relief for certain Part 7A charges; and proposals to widen the circumstances in which HMRC can pursue employees for unpaid disguised remuneration tax liabilities. The proposed rules leave little room for manoeuvre, and they contribute to an ever more complex and demanding piece of legislation.

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What is the background?

The disguised remuneration legislation introduced in FA 2011 was a warning to employers and promoters of tax avoidance schemes that the use of employee trusts and other contrived remuneration structures to avoid, defer or reduce income tax liabilities would be strongly challenged.

Publication of the draft legislation was met with extensive criticism in light of its wide ranging nature and its potential for catching innocent arrangements that did not involve tax avoidance. Following a series of amendments to the draft rules, Part 7A of ITEPA 2003 was enacted, which includes a series of complex exclusions and reliefs for certain types of deferred remuneration and employee benefits arrangements, HMRC approved pensions and share plans. Guidance on Part 7A is contained in HMRC's *Employment Income Manual* starting at EIM45000.

The key drivers for the legislation were to clamp down on the use of employee trusts to provide benefits (often representing unpaid bonuses) by way of tax-free loans to employees or their family members; and to limit arrangements which provided pension benefits in excess of the annual and lifetime limits on tax relief introduced from 6 April 2011 – typically through employer funded retirement benefit schemes (EFRBs). Part 7A has largely been a success, with HMRC claiming it has 'protected' £3.9bn of tax to date.

The disguised remuneration legislation was accompanied by a series of settlement opportunities offered by HMRC, covering various avoidance schemes operated prior to 2011:

- The EBT settlement opportunity: This offered incentives for companies to settle unpaid income and national insurance contribution liabilities arising in respect of loans and benefits made available to employees through employee benefit trusts (EBTs) and family trusts.
- The EFRBs resolution opportunity: This enabled companies with open enquiries regarding corporation tax relief claims, in respect of unapproved pension arrangements, to reach settlement terms with HMRC.
- The contractor loans settlement opportunity: This was offered in cases where UK resident contractors had entered into arrangements with offshore companies to receive remuneration for UK duties in the form of foreign currency loans (with exchange rates which could be manipulated).

These three opportunities were closed in 2015 but, according to HMRC, have netted approximately £1.5bn in tax revenues.

Despite HMRC's successes, it is clear that a number of arrangements which were implemented prior to the introduction of Part 7A still remain in place; and that new, ever more contrived and aggressive schemes have been created which exploit the perceived loopholes in Part 7A.

What are the new measures?

A number of measures will be introduced in the Finance Bill 2016. None of these will change the landscape in any radical way. They include the introduction of a new targeted-anti avoidance rule (TAAR), with effect from 16 March 2016; the withdrawal of relief on investment returns after 30 November 2016; and some minor technical changes to Part 7A.

However, of much greater impact are the changes proposed to be enacted in the Finance Bill 2017. These include: a new tax charge on all existing loans which remain outstanding on 5 April 2019; a new Part 7A gateway for schemes involving close companies; restrictions on the availability of corporation tax relief for certain Part 7A charges; and proposals to widen the circumstances in which HMRC can pursue employees for unpaid disguised remuneration tax liabilities.

The government is currently consulting on these measures, following the publication of a technical consultation document and draft legislation on 10 August 2016 (see www.bit.ly/2biEhBv). This is a welcome approach, given the extensive rewrites of the original Part 7A and signals a willingness to ensure legitimate transactions or situations are exempted from the new rules. Comments should be submitted by 5 October 2016.

What are the changes in the 2016 Finance Bill?

TAAR

The new TAAR is included in ITEPA 2003 s 554Z8. This section provides that no disguised remuneration charge arises where, on a transfer of value from the third party, the employee provides consideration at that time. This has been a particularly helpful relief in the context of employee share schemes, where shares are sold by the trustee of an EBT to employees at market value. It appears that certain contrived arrangements have been used to extract real value from EBTs; in particular, in the context of unapproved pensions. Going forward, these measures will only be effective if there is no connection (direct or indirect) between the consideration given and a tax avoidance arrangement.

Changes to the para 59 credit

The provisions in FA 2011 Sch 2 para 59 broadly provide

that where a tax charge arose or a settlement was made in respect of a pre-2011 step, credit for any tax liability is provided when a further disguised remuneration charge arises. For example, if a sum of money had been earmarked for an employee prior to Part 7A coming into force and tax was paid for this under the EBT settlement opportunity, no further charge would arise when the asset was transferred to the employee.

Paragraph 59 credit was also available in respect of any investment returns arising (subject to those which might arise under the transfer of assets abroad rules). So, for example, if assets had been earmarked and sitting in an EBT growing in value, relief would be provided on the whole value when it was distributed. Perhaps recognising that this had been too generous and in a clear attempt to promote further settlements, credit will now only be available if tax on the original step is paid before 1 December 2016.

Further amendments are also included to make clear that payments on account of tax, and those made under accelerated payment and follower on notices, cannot be taken into account for the purposes of para 59 credit.

Apportionment under s 554Z2

Finally, a minor change is being made to ensure that when more than one person benefits from a step giving rise to a Part 7A charge, the tax liability can be apportioned between them on a just and reasonable basis.

What's proposed in the 2017 Finance Bill?

HMRC's consultation makes clear that the government is aiming for the final legislation to be targeted and effective, but warns that it will continue to take action (including action backdated to November 2015) if anti-avoidance persists. Whilst the measures are not surprising, given the high profile nature of the issue, the changes are potentially very far reaching and will have serious consequences for those with existing arrangements.

Outstanding loans

One of the problems with the original legislation was that it did not address outstanding loans made before Part 7A came into force. Given HMRC's lack of consistent success in challenging this type of anti-avoidance in the courts and the inherent risks in trying to achieve a favourable set of terms under the EBT settlement opportunity, some companies took the view that arrangements should be left in place indefinitely. This approach will now be untenable as the proposals introduce a new charge on all loans made to employees or director (or their nominee) that fall within the Part 7A gateway and which remain outstanding at the end of 5 April 2019. This will include 'contractors' who worked under a contract of employment.

The definitions of loan and quasi loans are broad. They include all forms of credit and payments purported to be by way of loan, rights to receive payments or transfers of assets (including non-fungible assets or those which do not exist at the time the arrangement is made).

The tax charge attaches to the principal sum loaned and any further amounts added (including any accrued interest), less amounts repaid by the borrower. The technical guidance warns against attempts to circumvent the charge by artificial repayment methods; and the draft legislation includes a TAAR which disallows 'repayments' that are linked to further avoidance arrangements. Loans which are released or written off will only be treated as 'repaid' to the extent that they are taxed under the amended ITEPA 2003 Part 7A or s 188. This means that serious consideration will need to be given to all pre-existing arrangements. If loans are repaid before the 6 April 2019 deadline, the charge will be avoided; however, it seems inevitable that sums will then be trapped in EBTs, which will be subject to further income tax charges when paid out.

The loan charge will not however apply to loans made prior to 6 April 1999 or to 'approved fixed term loans'; broadly, these are loans made before the introduction of Part 7A with a repayment period of less than ten years which have not been replaced or had their terms amended and meet the qualifying payments or commercial terms condition. The qualifying payments condition requires a repayment of principal to have been made at least once every 53 weeks from the date the loan was made. The commercial terms condition covers loans which may fall outside the exclusion in Part 7A s 554F; broadly, these require the lender to be in the business of makings loans and the loans to be made on terms that are available to the general public.

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The existing exclusions in ITEPA 2003 ss 553E–554Y will also apply to the new charge.

HMRC recognises that where employees have been required to pay an accelerated payment in respect of a loan under Finance Act 2014 Part 4, they may be unable to find the funds to repay it. Provisions have therefore been included to allow those affected to postpone the loan charge, provided the remaining loan balance is equal to or less than the accelerated payment.

Anti-double taxation provisions will apply to prevent the loan charge arising where income tax has already been paid in respect of the loan or on the amounts used to provide the loan, including where loans have been included in a settlement reached with HMRC, except for those achieved under the contractor loans opportunity. Where tax was due but has not been paid, relief will be provided on the basis that each liability is a payment on account of the other. This will prevent situations where avoiders could be in a more beneficial situation by incurring a later Part 7A charge.

There is no relief given from benefit in kind charges which arise in respect of interest free or beneficial loans. However, the current rules already provide that where a loan gives rise to a Part 7A charge, no further beneficial interest charges arise. This treatment will be extended to the new provisions.

Loan transfers

One of the principal drivers for the disguised remuneration legislation was an attack on loan arrangements provided by third parties. HMRC is therefore now seeking to curtail arrangements whereby the employer makes the initial loan (which in most cases is not caught by Part 7A), but a series of steps follow which result in the loan being owed to a third party. The changes will make it clear that arrangements which ultimately result in an employee being in debt to a third party will be caught. However, there is a sensible carve out, where the loan was made by the employer and the third party who results in the indebtedness becomes the employer. The exclusion for commercial loans at ITEPA 2003 s 554F will continue to apply.

Close companies: the new Part 7A gateway

The existing legislation requires arrangements to come within what HMRC calls the 'Part 7A gateway'. In order for it to do so, there must be an arrangement which relates to an existing, former or prospective employee or a relevant person linked to the employee. The arrangement is, 'in essence', wholly or partly a means of providing rewards, recognition or loans in connection with employment. Under the arrangement, a 'relevant third person' takes a 'relevant step'; and it is reasonable to suppose that, 'in essence', the step is pursuant to the arrangement or there is some other connection (direct or indirect) between them.

Some anti-avoidance schemes, particularly those operated in respect of closely held companies, have been structured so that arguably there is no connection with employment; and for which the primary purpose is a result of some other reason, such as the director or employee's shareholding or control within the business. The draft legislation therefore proposes a new close company gateway, similar to the existing Part 7A gateway but which applies where the individual has a 'qualifying connection' with that close company and where both the individual is a party and the company is a party to or facilitates the arrangement. A qualifying connection arises where the individual is a former or current employee or director of the close company and has at any time held a 'material interest' in it. The definitions of director and material interest are taken from the existing definitions in ITEPA 2003 ss 67 and 68 respectively.

HMRC's technical note recognises that there may be an overlap with the loans to participators rules in CTA 2010 Part 10 and ITTOIA 2005 s 415, but that steps will be taken to ensure that no double taxation arises. Presumably, HMRC will want to ensure that Part 7A will take priority.

Transfer, release and writing off of loans

The proposed draft legislation includes new provisions which significantly widen the definition of 'relevant steps' to include the transfer, release and writing off of loans (using the broader language of the draft legislation on outstanding loans described above). This cements HMRC's view that disguised remuneration loans which are not taxed as employment income fall within the employment related loans provisions of ITEPA 2003 s 174. However, the release or write off of a debt following death will not be a chargeable event, in line with the treatment afforded under ITEPA 2003 s 188.

Changes to corporation tax relief associated with Part 7A charges

One of the historic drivers for the use of EBTs to provide remuneration was the ability to claim a corporation tax deduction in respect of the funding of the EBT, long before the cash was used to provide taxable benefits for employees. The landmark case of *Dextra Accessories Ltd and others v CRC* [2005] STC 1111 put paid to the practice and legislation introduced in FA 2003 Sch 24, provided that a deduction would only be available where benefits in the form of earnings were provided. Typically, where a Part 7A charge arises there is a corresponding ability to claim corporation tax relief. However, companies have continually found ways to claim 'upfront relief', in circumstances where income tax charges are avoided.

To further deter such planning, HMRC is proposing legislation that would deny corporation tax relief for contributions to disguised remuneration schemes, unless income tax and national insurance contributions are paid at the time of the contribution (even if Part 7A charges arise subsequently). HMRC views this as a strong deterrent to those considering such schemes. No draft legislation has been provided, but it is anticipated that this would apply to contributions made on or after 6 April 2017.

> Despite the OTS's call for a detailed review of Part 7A to simplify its language, reduce its length and make it more accessible, we appear to be faced with an ever more complex and demanding piece of legislation

Transfer of liability

HMRC's technical note provides a number of proposals to widen the circumstances in which HMRC can transfer the liability to meet Part 7A income tax and national insurance contributions liabilities from the employer to employees, on the basis that the employee is the ultimate beneficiary of the scheme and should pay his or her fair share of tax. These proposals build on the existing transfer of liability powers which are contained in the Income Tax (PAYE) Regulations, SI 2003/2682 (following a regulation 80 determination). They target scenarios where enforceability against the employer is problematic, for example where a non-UK employer is established for the purposes of the scheme, where the employer is no longer able to meet the Part 7A liability or no longer exists.

Final thoughts?

Employers and practitioners will need to carefully consider how best to tackle the obvious implications for existing arrangements, but there appears to be little room for manoeuvre. Despite the clear challenges of enforcing such retrospective measures, HMRC has equipped itself well to boost the Treasury's coffers. Settlement might be worth considering, but HMRC's publication on 31 August 2016 of the terms which are available following closure of the EBT settlement opportunity are not encouraging. They seem likely to provide less generous results than were on offer previously and do not appear to provide new incentives.

It is clear that achieving targeted and accurate legislation to stamp out further avoidance will be challenging moving forward. However, coupled with HMRC's plans to clamp down on the promoters and 'enablers' of avoidance schemes, it seems it is covering all bases. From a practitioner's perspective, despite the Office of Tax Simplification's call for a detailed review of Part 7A to simplify its language, reduce its length and make it more accessible, we appear to be considering an ever more complex and demanding piece of legislation. ■

For related reading visit www.taxjournal.com

- Your guide to Finance Bill 2016 (Claire Hooper, 30.3.16)
- EBTs: where are we now? (Nigel Holmes, 3.8.16)
- EBT settlements in practice (James Hume & Steve Edge, 24.1.13)
- FA 2011: Disguised remuneration (Karen Cooper & Natalie Smith, 3.8.11)