EMPLOYMENT INCOME PROVIDED THROUGH THIRD PARTIES (DISGUISED REMUNERATION)

DRAFT FINANCE BILL 2017 LEGISLATION: CLAUSE 32 & SCHEDULE 10

ICAEW welcomes the opportunity to comment on the draft Finance Bill 2017 legislation published by HMRC on 5 December 2016

This response of 1 February 2017 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

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POLICYMAKING AND CONSULTATION TIMING

COMMENTS

Our concern
We are concerned that some of the legislation will not work in practice.

Our recommendation
We urge the government to provide a detailed policy objective for the proposed changes so that consideration can be given to whether the draft legislation is the best method of achieving that objective or whether a targeted approach would better meet that objective.

Our concern
As noted above, we welcome the opportunity to help make the legislation better, but being asked to do this during the period leading up to the self assessment deadline means that many of our members who normally contribute to our representations are otherwise engaged in ensuring that their clients' tax returns are submitted on time and therefore they are unable to spend time on non-remunerated work.

Our recommendation
We suggest that personal including employment taxes consultations that extend over the 31 January self assessment deadline have response deadlines set in mid-February at the earliest, rather than, as in this case, 1 February.

CLAUSE 32 & SCHEDULE 10: LOANS AND QUASI LOANS OUTSTANDING ON 5 APRIL 2019

GENERAL COMMENTS

We reiterate our comments made in our response to the summer consultation ICAEW REP 150/16 that the measure:

- contravenes generally accepted notions of fairness and breaks the constitutional convention against retrospective legislation, imposing tax charges in cases where taxpayers already had legal certainty that none were due,
- is at variance with HMRC's arguments in many court cases (successful to date) that monies paid via employee benefit trusts (EBTs) and employer funded retirement benefit schemes (EFRBS) were actually earnings that should have been subject to PAYE and NIC,
- are aggressively retroactive against taxpayers who have not done anything that would under current rules leave themselves open to a 20 year assessing window which currently requires HMRC to demonstrate that there has been a deliberate inaccuracy in a return, especially as HMRC has been aware of loans to employees since at least 1999 and has failed to open inquiries or raise assessments before the expiry of statutory deadlines,
- affects transactions which were entered into up to 17 years ago where HMRC has taken no timeous action despite knowledge of the alleged avoidance and so is likely to lay the proposed legislation open to challenges under the Human Rights Act,
- contrasts with the favourable terms given to so-called tax evaders under the former Liechtenstein Disclosure Facility even though the taxpayers disclosed the loans at the time, and
- is unnecessary given that many of the outstanding cases are covered by existing legislation, in particular the s554A gateway which could be applied instead of HMRC proposing new legislation.

SPECIFIC COMMENTS

1. THE TAX CHARGE

The measure
A tax charge on loans arises from para 14 which deems an individual to have taken a "relevant step" on 5 April 2019; this gives rise to a tax charge on the value of all the loans then outstanding. This will presumably be at whatever the current marginal rate of tax is for the person.

Our concern
Given that if the loans had been taxable income when they were granted the employee would have been liable to tax at progressive rates and depending on their other income maybe even have been able to offset their personal allowance against the amount chargeable, and given that when the loans were entered into they were not taxable (other than under the beneficial loans rules), we believe that is penal and therefore disproportionate to aggregate all the loans to ascertain the tax chargeable on 5 April 2019.

Our recommendation
In the interests of fairness, the tax charge on the loans should be top sliced in accordance with the number of years over which the loans were granted.

Our concern
The primary payer is the employer, as is proper for an employment tax. However the 'condoc' originally proposed that the liability might be transferred to the employee where the employer could not pay, had ceased to exist or was offshore. We cannot find this in the draft legislation.

Our recommendation
We should welcome clarification of whether this proposal has been dropped, or, if not, when we can expect to see draft legislation on this point.

Our concern
If liabilities are to be transferred to employees, there are additional problems of quantum and availability of records. Where HMRC do not know what an employee has received in the way of loans, they are assuming that they come to six times basic salary. Such estimates are excessive in most cases. In addition, it is simply too long ago for employees to be able to recover records from third parties. For example, a member's client went to the trouble of asking a household name bank for his statements from 2007, and was told that the bank no longer had the information. Likewise many employees will have no idea who the trustees were who lent them the money so many years ago, or who the employer was (assuming that the employer is not defunct). Bearing in mind that the law does not normally expect people to keep records for more than six years, this is again unjust. Whilst we acknowledge that government has no sympathy for people who became involved in these schemes, this does not entitle the government to tax the individuals on made-up figures.

Parliament allows HMRC to assess six years in cases of careless (as opposed to deliberate) error, provided HMRC takes action within that six year window. Few, if any, of those taxpayers involved in disguised remuneration schemes will have filed inaccurate returns, either carelessly or deliberately.

Our recommendation
In the light of the above including our General Comments coupled with the fact that this situation has continued so long with the tacit approval of HMRC, we believe that the provision should not be affect loans made earlier than when the government announced its intention to take action.

2. THE CLOSE COMPANY GATEWAY

We set out below the text from representations that have been made already to HMRC on this issue.

TEXT OF COMMENTS SUBMITTED ON 9 JANUARY 2017 TO HMRC

As promised please find below some comments on the Close Company gateway contained in Sch 10 of the draft Finance Bill (dFB). […]

Our original email back in October (which is also below for your ease of reference) outlined our concern that the effective removal of the link between the part 7A charge and employment duties would lead to many unintended consequences. The two areas we focused on in that email were commercial transactions and foreign resident trusts (settled by non-doms); but that is not to say that there are not unintended consequences outside of these two areas.

Speaking for myself, and as mentioned in the October email, it was not clear to me that all the unintended consequences could be removed by tweaking the draft legislation as I felt that the range of unintended scenarios caught by breaking the link with employment duties was too wide for us to be sure that the tweaks would always be effective. I must confess it is still not clear to me how the legislation can be restricted to dealing with disguised remuneration when there is no test to effectively determine whether remuneration is being disguised (c.f. s554A(c) *…is a means of providing…rewards or recognition or loans in connection with A's employment…*).

Having considered the draft legislation in Sch 10 of the dFB it appears that there is still considerable scope for unintended scenarios to be caught by the proposed changes and this must be especially the case for commercial transactions where the terms can vary so considerably from one deal to another.

Below are two relatively simple examples which appear to fall within the scope of the proposed changes but which presumably are not intended to be caught.

As mentioned before, commercial transactions can be life changing events for entrepreneurs and can indeed be the culmination of a life's work. Any uncertainty over the tax treatment (and we are talking about potentially 10% CGT rate v 45%+ rate) could be very harmful and counter to the policy objectives behind entrepreneurs' relief. And likewise for non-doms, replacing the remittance basis with a 45%+ rate would appear to run counter to the policy objectives behind the current reform.

Commercial Transaction

Mr A owns Company B and is the sole director. Company C wishes to buy 40% of Company B. Company C will pay Mr A £100 now and £80 in 18 months. To fund the £80, Company C will request and receive a loan from Company B to assist with cash flow. It is agreed the loan will be interest free and be repaid after 2 years.

Chapter 2 applies if— (a) an individual ("A") has a qualifying connection with a close company ("B"),	Yes.
(b) there is an arrangement ("the relevant arrangement") to which A is a party or which otherwise (wholly or partly) covers or relates to A,	The SPA.
(c) it is reasonable to suppose that, in essence— (i) the relevant arrangement, or	Yes, the sale will provide cash to Mr A.

(ii) the relevant arrangement so far as it covers or relates to A, is (wholly or partly) a means of providing, or is otherwise concerned (wholly or partly) with the provision of, A-linked payments or benefits or loans,	
(d) B enters into a relevant transaction (see section 554AB),	Company B pays cash to Company C to fund the £80. Company B is not a group company. This appears to be within s554AB(2)(a). It is not an excluded transaction under s554AC which states: *(1) In section 554AB, "excluded transaction" means—* *(a) a distribution made by B,* *(b) a transaction that—* *(i) is entered into by B in the ordinary course of B's business, and* *(ii) is on terms that would have been made between persons not connected with each other dealing at arm's length, or* *(c) a transaction entered into in order to facilitate the disposal, on terms that would have been made between persons not connected with each other dealing at arm's length, of shares in B.* *(2) Sections 1030 to 1030B of CTA 2010 are to be disregarded in determining what is a "distribution" for the purposes of this section.* *(3) But a transaction is not an excluded transaction if there is a connection (direct or indirect) between the transaction and a tax avoidance arrangement.* It does not appear to be excluded because it is not a distribution 1(a), it is not entered into in the ordinary course of business 1(b) and it is not arm's length 1(c). It appears therefore to fall within the definition of a relevant transaction.
(e) it is reasonable to suppose that, in essence— (i) the relevant transaction is entered into (wholly or partly) in pursuance of the relevant arrangement, or	The loan up to Company C is linked to the purchase of Company B (the draft refers to direct or indirect connection).

(ii) there is some other connection (direct or indirect) between the relevant transaction and the relevant arrangement,	
(f) a relevant step is taken by a relevant third person, and	There will be the payment of the £80 in 18 months' time.
(g) it is reasonable to suppose that, in essence— (i) the relevant step is taken (wholly or partly) in pursuance of the relevant arrangement, or (ii) there is some other connection (direct or indirect) between the relevant step and the relevant arrangement.	Yes.

Offshore Family Trust – capital payment

Non-dom (A) set-up a trading group (B) years ago and transferred the group into an offshore trust (C) for various reasons totally unrelated to the UK. He then, at a much later date, came to the UK with his family. He is currently taxed on the remittance basis. The trustees (C) wish to provide a French summer house for the settlor's (A) use. To do this they borrow from company B interest free repayable on demand and use the money to buy a house in France which the settlor may occupy as he desires.

Chapter 2 applies if— (a) an individual ("A") has a qualifying connection with a close company ("B"),	Yes. He is a former director and former 100% owner.
(b) there is an arrangement ("the relevant arrangement") to which A is a party or which otherwise (wholly or partly) covers or relates to A,	Yes the relationship with the trustees and the settlement itself.
(c) it is reasonable to suppose that, in essence— (i) the relevant arrangement, or (ii) the relevant arrangement so far as it covers or relates to A, is (wholly or partly) a means of providing, or is otherwise concerned (wholly or partly) with the provision of, A-linked payments or benefits or loans,	Yes this is the purpose of the trust.
(d) B enters into a relevant transaction (see section 554AB),	It provides cash to trustees. For the same reason as above it does not appear to be an excluded transaction.

(e) it is reasonable to suppose that, in essence— (i) the relevant transaction is entered into (wholly or partly) in pursuance of the relevant arrangement, or (ii) there is some other connection (direct or indirect) between the relevant transaction and the relevant arrangement,	This appears to be met as the whole point of the trust is to provide A linked benefits.
(f) a relevant step is taken by a relevant third person, and	Provision of the property for use appears to fall within s554D.
(g) it is reasonable to suppose that, in essence— (i) the relevant step is taken (wholly or partly) in pursuance of the relevant arrangement, or (ii) there is some other connection (direct or indirect) between the relevant step and the relevant arrangement.	This appears to be met as the whole point of the trust is to provide A linked benefits.

I would be interested to hear if you agree with the analysis above.

Comments submitted to HMRC in October 2016

> […] As promised please find below some additional thoughts on the proposed Close Companies' Gateway as it relates to both commercial transactions and non-doms. […]
>
> **Commercial Transactions (i.e. certain disposals of companies)**
>
> As discussed yesterday I am certainly of the view that breaking the link between employment duties and the charge under Part 7A is unwise and I would fear that this proposal could potentially impact a whole host commercial transactions (i.e. disposals). Yesterday you did advise that this was not the intention and you did not believe that such transactions would be caught but I think I would just reiterate that this is an area where any uncertainty at all should be avoided and that ideally I think there should be some form of bright line test upfront in the legislation. Bringing commercial transactions within Part 7A and then hoping to take them back out should be avoided I think as, undoubtedly, some transactions may not be successfully removed from the charge.
>
> If I recall correctly, I think you were of the view that s554Z8 would generally act to remove the Part 7A charge (consideration paid). I do wonder if this will work for all deal types (and no two deals are the same). For example, would it be sufficient to deal with an earn-out? S554Z8 leaves a residue Part 7A charge where the value of the relevant step exceeds the market value of the asset transferred – is there therefore a risk that an earn-out will be left over as a residue and so caught by Part 7A?
>
> Trying to use highly prescriptive legislation to take commercial transactions back out of Part 7A seems to me to be a tricky business. And using guidance as a fall-back would not be

attractive at all in this space as these are life changing events for taxpayers and they require certainty over the tax position up-front.

Non-Doms

It occurred to me during the meeting that these proposals could pose some serious issues for the archetypal non-dom entrepreneur. I must confess I haven't had the time I require to investigate this fully so I may have missed something obvious which means this is not an issue. If so I apologise; I am working on the basis that it is better to flag it and be wrong than remain silent!

The non-dom (A) may have set-up a trading group (let's call this B) years ago and transferred the group into an offshore trust (call this C) for various reasons totally unrelated to the UK. He may then at a later date come to the UK with his extended family.

On a precursory reading of the Close Company Gateway it would appear that all benefits provided to him and his family could be subject to employment income and presumably NIC as follows:

1. He has a qualifying connection – he used to be a director and owned 100% of B
2. There is an arrangement – it certainly is drafted wide enough to include within its scope a trust;
3. B (the trading group) is party to that arrangement – it is owned by the trust and pays up dividends;
4. In this case the arrangement is explicitly to provide benefits to A and his family;
5. A relevant step is taken by the trustees C – they provide a benefit.

I am therefore a bit concerned that all benefits provided to A and his family by the trustees are potentially caught by Part 7A and charged as employment income (with NIC!!). I would be interested to hear if you agree or, if not, why you think it falls outside the proposals.

I would just add that, if I am correct to be concerned, while this may seem like an extreme example which can be removed from scope by some minor changes, I am not sure that is correct and it is very easy to think of other mainstream non-dom examples which cannot be tweaked around.

I think, as discussed yesterday, the real issue here to my mind is that once the link between the tax charge and the employment is broken then Part 7A (which is drafted very wide) spills out across all taxes with unforeseen consequences.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see http://www.icaew.com/-/media/corporate/files/technical/tax/tax-news/taxguides/taxguide-0499.ashx).