TAXREP 28/11

FINANCE BILL 2011

CLAUSE 26 AND SCHEDULE 2, EMPLOYMENT INCOME PROVIDED THROUGH THIRD PARTIES

Further Parliamentary briefing submitted at Public Bill Committee stage on 16 May 2011 by ICAEW Tax Faculty setting out concerns with the 'disguised employment' provisions published in the Finance Bill 2011 as amended for the Government amendments tabled on 11 May 2011.

Contents	**Paragraph(s)**

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Introduction

1. We submitted a Parliamentary Briefing to members of the Public Bill Committee on 12 May 2011 (Editor's note: subsequently published as TAXREP 27/11). This set out our key concerns with these provisions.

2. The previous day, the Government published an extensive list of amendments that had been tabled in respect of these provisions. When we published our above comments, we had not had the opportunity to review the latest set of amendments. In view of the general concern about these provisions and the requests we have received about whether we have some more detailed comments, we have prepared this more detailed briefing with the assistance of an ICAEW member who specialises in this area, Martin Benson of Baker Tilley, and who has advised us on the previous drafts of these rules.

3. Following our (unpublished) comments to HMRC on the version of the legislation circulated on 15 March 2011, we are pleased that a number of amendments have been made to the Finance Bill and the latest tabled amendments which take on board some of our concerns.

Major concerns

4. Our major concerns with these proposed rules still remain. We believe that this legislation is still far too widely targeted. It catches far too many innocent and/or commercial transactions. Our particular concerns with the principles underlying this draft legislation are set out below.

   a) It remains the case that as drafted tax liabilities will still arise in circumstances where the employee in question may receive no value from the arrangement, either when the taxable 'relevant step' is taken or at any later time. We expand on this below.

   b) There is limited scope for an officer of HMRC to give relief where the earmarking rule (s 554B) applied to a transaction and tax was paid but the employee ultimately receives no benefit (s 554Z13). There is clearly no such scope for tax/NIC to be refunded if the employee ultimately receives less or no benefit from steps taken under s 554C or D. This contrasts sharply with the current anti avoidance provision for loans to participators in close companies, under which the tax payable (at generally far lower rates) is refunded when the loan is repaid (s 455, CTA 2010). The charge on the advancement of loans, which may be perfectly genuine loans and which may be repaid within a short period, is iniquitous and will impose an extremely disproportionate penalty on those who fail to take advice before proceeding.

   c) The tax charge is not confined to circumstances which are motivated by tax avoidance. A wide range of innocent and normal commercial transactions and arrangements will be caught, forcing employers and employees to pay tax/NIC in circumstances where as a matter of policy we believe it is not right that they do so.

   d) A large body of statute law and centuries of case law have led to a complex but reasonably well understood basis for charging tax on 'earnings' and deemed earnings, with extensive and detailed exemptions and deductions. All of that is now largely overridden by the uncertain but clearly wider terms 'recognition' and 'reward' which are not subject to many exemptions and deductions applying to earnings. This can result in disproportionate tax charges arising which bear little or no relation to the actual benefit that may be received by the employee.

e) We note that a number of new exclusions have been introduced. In general the exclusions apply to specified steps but apart from the particular connected arrangements dealt with in s 554E (steps involved in acquiring and earmarking shares for approved share schemes) there is nothing to exclude steps taken in order to undertake the excluded steps. For example, where an employer runs into financial difficulty and a third party (a founder or a new investor for example), undertakes to provide cash flow to fund salaries for a period, the mere calculation of a budget for a forthcoming period would in principle trigger Part 7A charges on those salaries at the time when the commitment is made which may be months or years in advance of their being earned. Numerous other examples will arise in practice.

5. As noted above the draft legislation is far too widely targeted. We give examples below but many others are likely to arise in practice. These unfair and unreasonable charging provisions will inevitably distort commercial practice and impose disproportionate tax costs on the unwary. There is a danger that these changes will damage the UK's competitiveness and growth prospects and in particular the Government's growth agenda.

6. Set out below are our comments on particular provisions. In view of the short timescale for comments we may return to this matter with a further Parliamentary briefing at Report Stage.

Detailed comments

Interaction with other parts of the existing law

7. We do not believe the overlap between Part 7A and other parts of the existing law have been considered with sufficient care. As an example, the 'IR35' personal service company legislation contains specific PAYE charging rules where an individual provides his services through the medium of his own service company and his working arrangements would amount to employment with the client if the contract had been directly between himself and the client. In those circumstances, PAYE must be paid by the service company at the end of the tax year even if the profit within the company has not been paid out or has been paid out as dividends, etc. Where the arrangement would not so amount to employment the IR35 legislation does not apply and the profits in the service company, and dividends, are taxed in the normal way.

8. Prima facie, Part 7A could apply to payments from the client to the service company, because the payment is 'in essence' reward for the work of the individual and it is paid to a person with whom he is linked (ie, a close company in which he is a shareholder), for the purpose of s 554C. Part 7A seeks to recognise the potential issue by permitting any amount falling to be taxed under the personal service company legislation to be deducted from the Part 7A taxable amount (s 554Z5(3)(c)). There are two problems with this:-

   a) The amount taxable under Part 7A must be determined with finality as each payment is made from the client to the service company, but the amount deducted from it is not calculated until the year end and can take into account various deductions the amounts of which may not be known at the time; and

   b) Where the IR 35 legislation does not apply because the employee would not be an employee of the client if the contract were direct, Part 7A applies to each payment made by the client to the service company and there is no deduction for any later IR35 deemed payment. In other words, the overall effect is that those who enter into 'disguised employment' and for whom the draconian and deeply controversial IR35 legislation was created enjoy more favourable treatment than those in 'innocent' personal service company arrangements.

When is an employer a third party?

9. We note that an employer is no longer himself to be treated as a third party for these purposes unless he is actually a trustee (s.554A(6)). We note also that a group company is similarly not to be treated as a third party unless it acts as a trustee. However, concerns remain:-

   a) The definition of 'group' for this purpose is unique (s 554Y(5) and (5A). Many employers are constituted as partnerships, limited liability partnerships (which are not 'companies' for tax purposes, (s 863, ITTOIA 2005) or members of foreign groups which do not satisfy the new definition but which are commercially similar. In these circumstances a step taken by a group entity which is not the employer will be caught.

   b) Many benefits, and share plans (and initial awards under them) in particular, are voted upon by shareholders (under the rules of a stock exchange, or institutional shareholder guidelines, or in private companies simply because the shareholders require it). A shareholder is prima facie a 'third party. If for example shareholders vote at a meeting to adopt a new share plan (not involving any employee benefit trust) and to make initial awards to named employees under it, are they taking a step under s 554C(1)(c)? Even if awards are not at that point made to any named employee, but awards are subsequently actually made are those awards not made 'by virtue' of the shareholders' vote to adopt the plan, and therefore caught? Is the conclusion that only share plans that are not approved by shareholders are outside the scope of Part 7A?

   c) Similarly, shareholders (ie, third parties) vote on dividends. If a dividend is voted on shares acquired by an employee, that dividend is now taxable under PAYE if it can be said that the dividend is in any way part of an "arrangement" intended to provide "recognition or reward" to the employee. All employee share plans are clearly a form of recognition or reward for employment and thus any shares acquired from, eg, an EMI option exercise, and dividends that flow from those shares, are arguably part of the same "arrangement". Where is the line to be drawn?

   d) Many employers engage external suppliers to perform administrative functions such as operating the payroll, bookkeeping, company secretarial services (completing share transfer forms and submissions to Companies House, etc), administering employee share plans, stockbroking, etc. Other third parties become involved in determining the levels of individual remuneration packages in various ways. These include:-

      (a) Employee benefit trust
      (b) 'Oldco' or 'Newco' on a reorganisation
      (c) Vendor or Purchaser
      (d) Founder/new investor/shareholder
      (e) Group entity under overseas law not satisfying Part 7A definition
      (f) Flexible benefit administrator
      (g) Share Plan administrator
      (h) Payroll agent
      (i) Relocation Agency
      (j) Liquidator
      (k) Conference organiser
      (l) Client/supplier
      (m) Subsidiary LLP
      (n) Pension plan trustees
      (o) Stockbroker
      (p) Government department
      (q) Company Secretarial service provider
      (r) Client
      (s) Travel agent
      (t) Lawyer with a client account

e) All such parties are potentially 'relevant third parties' whose involvement in holding, earmarking and transferring cash, shares and other assets may create tax charges that would not otherwise arise. Employers must now take all offending services in house. Businesses providing such services now have a threat to their viability. The severe limitations on the exemptions outlined below will render such commercially desirable arrangements highly dangerous.

f) The employer is also a third party if he 'acts as a trustee' (s 554A(7)). So if any entity established as a trust (many charities, voluntary organisations, etc) gives an employee a season ticket loan or similar, income tax is now payable on the amount of that loan even if it is repaid.

g) The meaning and intention of s 554B(5) to (8) is far from clear. It clearly draws a distinction between the making of a contribution to an unregistered pension plan on the one hand, and an earlier "earmarking" of funds by the employer on the other. If an employer simply offers an employee participation in an unapproved pension plan and commits to paying, say, 5% of salary into it each month as an employer contribution, has he 'earmarked' 5% of the employee's salary for these purposes simply by writing the promise in an assignment letter or employment contract? Is the answer different if the employer prepares business budgets on an annual basis and includes the cost in that budget for the year in question? If the employer draws up forecast business plans (which are often drawn up for 5 years or more in advance for the benefit of investors, banks, et al) has he thereby earmarked the 5% throughout the duration of the period covered by those projections and which include the cost? Or has the employer earmarked the 5% throughout the duration of the employee's future employment, with an immediate PAYE/NIC charge on the total?

Deferred remuneration and share plans

9. There are new exclusions for deferred remuneration which vests within 5 years. We believe this will be damaging to business for several reasons.

The 5 year rule

10. The limitation of the vesting period to 5 years for deferred pay will cause considerable and unnecessary difficulty in practice. We see no policy reason to impose a 5 year limit on conditional remuneration. If an employee, who has received nothing more than a promise that he may receive some remuneration in future if certain events happen, and may forfeit an award under such a promise 5 years and one week after the award is made, why in principle should he pay tax on the value of the sum or asset in question one week before forfeiting it? If it is accepted that this result is wrong, why is it any less wrong if the forfeiture occurs after 6 years or 10 years or 20 years, etc? The employee at no time receives anything of value but he must pay tax on the value of the sum or asset on the fifth anniversary.

11. The position may be contrasted with the existing 5 year rule for forfeitable shares in Chapter 2 of Part 7. If an employee receives forfeitable shares and the forfeiture period lasts more than 5 years, the employee must pay tax on (at least) the 'actual' market value at the date of grant. There is a policy justification for this, in that the employee enjoys the rights of ownership during the vesting period. He can vote and receive dividends. By contrast, the new Part 7A provision imposes tax at the 5 year point even though the employee at no time receives any benefit, and may have no funds with which to pay the tax.

12. Indeed, in many circumstances, taxpayers will be worse off than if this 'exclusion' had not been introduced. Under the previous draft an employee may have been obliged to pay tax on an initial (possibly low, in a start up company) value of 'earmarked' cash or assets. He may possibly also have been liable to income tax on a vesting on a sale of the company say 7 years later. At least in those circumstances he would have been liable to pay tax at a time when he

had some cash to pay it. Now he will be liable to pay tax on five years' worth of growth in value with no source of cash to pay it, no certainty of any actual benefit at any time, and unless a further change is made, with an obligation to pay tax on the tax, under s 222.

13. This is likely to cause particular difficulty in practice in the very common situation where awards vest only on a corporate 'exit' event, such as a sale of the company or group, a flotation or a winding up. These events are not limited by time. Any employer who wishes to incentivise his employees to work towards such an exit will now be unable to offer a plan permitting capital growth to be charged only to tax on an exit, wherever it is not feasible to exit within 5 years. If a plan were created which vested only on a sale if it occurs within 5 years this would create a huge and artificial disincentive from the fifth anniversary if the exit has not occurred by then.

14. Section 554I takes no account of the reduced value to be attributed to convertible securities under Part 7, and will thus again accelerate a tax charge in many innocent circumstances.

Pension plans

15. Many multinational employers have globally mobile workforces. Some employees are simply seconded from a home country to a host country for a period and then return to spend the remainder of their career in the home country. Other employees may be assigned to a series of countries in succession. It is common for such multinational groups either to allow employees to continue to participate in their home country pension plan, or to establish one or more international pension plans in which employees participate only when they are assigned away from their home country. Such plans may be administered and funded centrally and may or may not involve recharging funding costs to host country subsidiaries.

16. Few such plans qualify for migrant member relief, double taxation relief or 'grandfathered' corresponding acceptance (the burden placed on overseas administrators to report 'benefit crystallisation' events is in practice too great). Further, in many instances, no income tax will have been paid on employer contributions in the past, either because such contributions were exempted from 6 April 2006 or because before then, the contributions were not paid by the employer and were not chargeable under the predecessor legislation (s 595, ICTA 1988).

17. .Any such employer with assignees to the UK who participate in such plans must now establish new procedures to track the movements of assignees around the world throughout the period up to the final payment of any benefit from the plan which may be decades in the future. Such individuals will retire and receive a lump sum and/or pension. In some cases the pension income itself will be exempt by virtue of a double tax treaty. In others it will not and proportionate charges will be made. In some cases the individual will receive a lump sum on retirement and that may not be pension income for the purpose of a double tax treaty and must now be identified and taxed. The record keeping implications for those affected are considerable and we believe will leave the UK out of line with most other countries in the world. This will amount to a further substantial disincentive to bringing employees to the UK.

18. A cash payment of a lump sum which is attributable to service before 6 April 2011 continues to enjoy exemption under ESC A10 (as amended) but a transfer from one unapproved plan to another of funds arising from such service are fully taxed, unless the scheme is a regulated overseas scheme (s 554W).

19. There are many bona fide international pension schemes that are not regulated as such in the territory in which they are based. This will be a major issue for many of them. There is no obvious policy reason why a transfer from one scheme to another should be more heavily taxed than a lump sum payment.

Loans

20. The exemption for loans is not broad enough. Loans are of course caught even if they are not in the nature of ’reward or recognition (s 554A(1)(c)). If the lender (normally a group company separate from the employer which is set up to qualify to make loans under the consumer credit legislation) charges a commercial rate of interest but does not make similar loans to the public, the exemption is not available. This is despite the fact that the employee will have received no more benefit than if he had obtained the loan from a high street bank.

21. Loans are given to employees for a variety of perfectly good commercial reasons: to relocate to be near their work, to obtain season tickets to get to work, to relieve hardship when an employee is in a temporary financial crisis, ’cashless exercises’ of share options, tax loans to international assignees, and so on. These loans are often administered by third parties and are generally repaid. As a matter of policy it is not right to impose a PAYE/NIC charge on the amount advanced in these and a variety of other circumstances.

22. The exemption in s 554M(7) is too narrow. Many cashless exercise arrangements administered by brokers following long-standing practice do not involve any formal loan agreement with the employee, but simply a few forms on which the employee indicates his preferred course for exercising the option, selling shares and receiving net sale proceeds. We suggest the word ‘loan’ should include ‘any form of credit’.

23. Part 7A proposes to impose s 222 liabilities (tax on tax where PAYE is not suffered by the employee within 90 days of a notional payment being made) on those caught by Part 7A. We remain of the view that that is an inappropriate and unfair imposition.

Employee benefit packages

24. The exemption for employee benefit packages is too restrictive. It is commonplace for employers to provide benefits of various kinds only to higher paid or senior employees. Company cars, medical insurance and so on are often confined to management grades, for example. Administration of benefit schemes is often outsourced to leasing companies, ’flexible benefit’ providers and so on. An attempt has been made to correct the problem (by amendment to s 554G(d)) such that the exemption may apply if the employee in question is of comparable status to all of those to whom it is available. However, this then conflicts with s 554G(3) so that if, for example, a benefit is provided only to directors, it appears that the exemption cannot actually apply.

25. The exemption for car ownership schemes in s 554M is also too narrow. There are many variations on car ownership in the market and employees may either purchase or hire or lease cars under arrangements set up between the employer and a leasing provider or administrator. Even a purchase may not involve a ‘loan’ as such but simply a purchase on credit. The exemption as drafted appears to require a formal loan agreement. We suggest that a loan should include any form of credit for these purposes. Further the limitation of the relief to loans outstanding for no more than four years will no doubt be welcomed by leasing companies (who will be able to charge more for the transfer of a less-depreciated car) but works against the interests of many employers and employees whose schemes envisage replacing cars only once every five years. It also arguably runs counter to the interests of the community at large as it encourages an increase in the number of cars on the road.

26. If the employer has an arrangement with a leasing company to provide cars only to employees above a certain grade and any of the terms of s 554M are failed, the allocation of a car may give rise to an immediate PAYE/NIC liability on the value of the car even though the employee may actually enjoy only the use of a car for a period. There will be considerable doubt about whether s 554D(7) applies in most car schemes which involve some mechanism for permitting the employee to purchase the car outright at the end of a leasing period.

Consideration given by employee

27. Section 554Z5 permits payments made (or assets transferred) by the employee to be deducted from amounts otherwise taxable under Part 7A. Again this is still too narrow. The deduction is permissible only from a charge arising under s 554C(1)(a) to (c). An employee's payment for any 'step' in Part 7A should be creditable against that step.

Relief where no benefit received

28. We note that s 554Z10 enables an officer of HMRC to provide relief where an 'earmarked' benefit ultimately yields no benefit to the employee. While this is a welcome improvement, we suggest it should be available in respect of all Part 7A charges, not simply charges arising under s 554B.

Reward or recognition

29. As we have indicated previously, s 554A(1)(c) introduces tax on 'rewards or recognition'. This is obviously different from and wider than 'general earnings' and 'specific earnings' as defined in ITEPA 2003. We maintain that the extension of the scope of the employment income tax charging provisions in this way is potentially very far reaching and requires further consideration. Case law has developed considerable clarification of the meaning of 'emoluments' and 'earnings' and the deeming rules associated with them, and of the exemptions and deductions available in respect of earnings.

30. Simply overriding this large body of legislation and case law with these terms will create uncertainty in a very wide range of circumstances (eg, compensation payments awarded by the courts, tips, training, many aspects of international assignments and tax equalisation policies, welfare and entertainment in various forms, etc) and is potentially damaging to the UK competitiveness.

31. We note that some of the exemptions in Part 4 are now to apply to Part 7A income but the amendment is still defective. Tax relief from Part 7A is available only in respect of 'employment income exemptions' (see s 554O(1)) and not in respect of 'earnings only exemptions' (see ss 227 and 228 ITEPA). So where an employee is given a fuel card to purchase petrol for private use in a company car he is chargeable to income tax on a fuel scale charge and is therefore given an 'earnings only' exemption in s 239 (see s 228) so that he does not also pay tax on the amount involved each time he fills the tank. However, now he will also pay tax under Part 7A each time he fills the tank (ie, in addition to suffering the fuel scale charge). Similar issues arise with all of the other 'earnings-only' exemptions.

32. The structure of new Part 7A also results in a limitation of the application of the deductions allowed in Part 5 of ITEPA. These are deductible only in calculating taxable earnings for the purpose of Part 2 (s 327(1)). Thus if an employee who works hard is 'rewarded' or 'recognised' by being allocated a task that involves an overseas business assignment that might happen to be in an attractive location, his expense reimbursements may be deductible from earnings under Part 2, but they may be wholly taxable under Part 7A.

Conclusions

33. We still believe that the current structure and fundamental principles underlying Part 7A are wrong. While we understand the wish to avoid leaving scope for abuse we do not accept that it can be right to impose severely penal tax charges on a wide range of very common commercial remuneration arrangements.

34. In general the tax that will be collected under this legislation will be paid mainly by employers and employees who do not take advice before taking the step in question. These will comprise mainly small employers who are not advised in this area, or foreign based employers whose

remuneration policies are designed without regard to the tax legislation of any particular country and who will seek advice only after assignments have commenced.

35. No matter how many such employers and employees are caught in practice, and no matter how much sympathy HMRC may have for their circumstances, they will be obliged to pay. It is clear from the recent appeals in *Chilcott* that neither HMRC nor the Courts would have the power to offer any relief from any disproportionate tax charges that will arise under these provisions.

36. More importantly, if employers can no longer offer deferred or conditional incentive plans through third parties and other commercially desirable outsourced service providers, without incurring disproportionate tax charges, and if all forms of loan through such parties are effectively now prohibited, and if the potential for innocent transactions to trigger penal tax costs that are not recognised until too late is to be so increased, these measures will damage the UK's competitiveness.

37. We believe that the basic principle underlying these provisions that all 'steps' are caught, whether motivated by tax avoidance or not, subject only to a list of specific exclusions, is wrong. It is not realistic to expect to cater for all of the potential variety of innocent transactions that will arise in practice by making specific provision for each example that is identified by this consultation. Commercial practices develop constantly and new circumstances and new questions arise every day.

38. We note the power to provide further exclusions by statutory instrument but that is not an adequate solution. The circumstances in which these provisions will bite will be many and varied and will arise at different times and HMRC will no doubt have difficulty finding time to deal with them on a case by case basis. In any event, the most damage this legislation will cause is the constraints that it places on innocent and compliant businesses to organise their affairs in a commercially appropriate fashion.

Further information

39.Please contact ICAEW if you require any further information.

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APPENDIX 1

THE 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/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-4-99-towards-a-better-tax-system.ashx).