THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW TAX FACULTY REPRESENTATION

TAXREP 14/11

DRAFT FINANCE BILL 2011: DISGUISED REMUNERATION – EMPLOYMENT INCOME THROUGH THIRD PARTIES

Comments submitted on 9 February 2011 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales on the proposed legislation on 'Disguised Remuneration – Employment income through third parties' published as part of the draft Finance Bill 2011 on 9 December 2010.

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DISGUISED REMUNERATION – EMPLOYMENT INCOME THROUGH THIRD PARTIES

INTRODUCTION

1. This document sets out the comments of the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) on the proposed legislation on **Employment income through third parties** published as part of the draft Finance Bill 2011 on 9 December 2010. This is referred to as 'disguised remuneration' in the note which accompanies the draft legislation.

2. These comments were sent to the HMRC officer responsible for this topic on 9 February 2011.

3. They are also included in our comprehensive response to the draft Finance Bill 2011, which is published as TAXREP 5/11 and was submitted to the Exchequer Secretary to the Treasury and to the Permanent Secretary for Tax at HMRC on 9 February 2011.

4. Information about the Tax Faculty and the ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's ten tenets for a better tax system, by which we benchmark proposals to change the tax system.

WHO WE ARE

5. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

6. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

7. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 11,000 members of the Institute who pay an additional subscription, and a free weekly newswire.

KEY POINTS

8. We welcome the decision to publish anti-avoidance legislation in advance for consultation.

9. However, we believe the legislation is too widely drafted and will catch too many innocent transactions. It will also create considerable uncertainty and compliance problems. All in all it will hinder the UK's competitiveness and stifle growth.

10. We have set out our detailed concerns about the legislation but overall we believe that the current structure and fundamental principles underlying this draft legislation are wrong.

11. We will be happy to work with HMRC to identify a set of rules that will be fit for purpose.

COMMENTS ON THE DRAFT PROVISIONS

General points

12. We commend the decision to publish anti-avoidance legislation for advance consultation.

13. We appreciate that HMRC consider legislation necessary to stop what they perceive as the abuse of Employee Benefit Trusts (EBT) and Employer Funded Retirement Benefit Schemes (EFRBS). It is entirely right that the government should seek to counter tax avoidance but any anti avoidance legislation should be properly targeted.

14. We believe that this legislation is far too widely targeted. It catches far too many innocent transactions. It will also create considerable uncertainty and compliance problems that will hinder the UK's competitiveness and stifle growth. Our particular concerns with the principles underlying this draft legislation are set out below:

    - As drafted tax liabilities will arise in circumstances where the employee in question may receive no value from the arrangement, either when the taxable 'step' is taken or at any later time. The legislation applies to many forms of *'disguised'* and/or *deferred* and/or *conditional* remuneration. All that is required is that there is a 'step' that may or may not lead to some form of advantage for the employee later.

    - There is no scope for tax/NIC to be refunded if the employee ultimately receives less or no benefit. 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 (section 455 CTA 2010).

    - 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, it is not right that they do so.

    - 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 vague, but clearly wider terms 'recognition' and 'reward' which are not subject to the 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.

15. As noted above the draft legislation is far too widely targeted. To take one example, an employer might arrange for a group company to make a bridging loan to an employee moving house on relocating for the purpose of employment. The loan might be for, say £1 million. It may be repaid with interest at a commercial rate within two weeks. Nevertheless under the new law, PAYE and NIC must be paid, without any prospect of a refund, on £1 million when the loan is advanced.

16. Other examples are referred to 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 bring the UK tax system into disrepute and will damage the attractiveness of the UK's competitiveness and growth prospects.

17. Set out below are our comments on particular provisions.

‘Wholly or partly’ reward payments are fully taxable

18. Section 554A (1)(b) and (c) (as inserted by paragraph 1 of draft Schedule 1) provide that a step is caught if it is ‘wholly or partly’ a means of rewarding the employee. Suppose an employer needs an employee to relocate quickly to another part of the country and offers, through its relocation agency or a parent company, to pay the employee the highest of 3 independent valuations for his existing home, in order to facilitate an early move. The payment arguably includes an element of reward or recognition and the employee is prima facie now taxable. The problem is that the employee is not taxed (as previously and correctly) on any **excess** over its market value but instead on the **whole** of the payment made to buy his house (section 554K(1)).

19. Similarly, if an employee sells shares in a private company to an employee benefit trust for what the parties believe to be the market value, there is now a risk that if HMRC consider after the event that the market value is even £0.01 (one penny) less in total than the price paid, then the **whole** of the purchase price is liable to PAYE/NIC. Valuation is inevitably a matter of opinion and the position is made worse by the fact that HMRC will not comment on a valuation in advance in these circumstances. Private companies that have limited markers in the company’s shares will now be faced with greater uncertainty about the tax treatment of substantial transactions.

Reward or recognition

20. Section 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. 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.

21. Simply overriding this large body of legislation and case law with these terms will create uncertainty in a very wide range of circumstances (e.g. 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.

22. The structure of Part 7A results in a limitation of the application of the exemptions in Part 4 of ITEPA. Some of those exemptions (e.g. the Christmas party exemption and long service awards) prevent liability from arising under any enactment and so would prevent liability arising under Part 7A. However, other exemptions remove liability only under Part 2 (section 228 ITEPA). Therefore they would not prevent a liability arising under Part 7A. These include mileage allowances, passenger payments, parking facilities, incidental overnight expenses, work related training, relocation expenses, and so on. If any of these ‘exempt’ payments involve any element of ‘reward or recognition’ they are wholly taxable (section 554K(1)).

23. Similarly, the deductions allowed in Part 5 of ITEPA are deductible only in calculating taxable earnings for the purpose of Part 2 (section 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.

When is an employer a third party?

24. Section 554A(7) and (8) provide that an employer may himself be a third party for these purposes if he ‘holds any sum of money or asset’, or ‘is responsible for the management of

any sum of money or asset' held under an 'arrangement'. An 'arrangement' also includes simply an 'understanding'. These words are potentially of very wide application.

25. Given that HMRC's guidance on 'arrangements' in other contexts indicates that an arrangement can include a decision taken at a meeting or a 'common practice' (see SP 13/91), virtually any 'step' taken by an employer himself may be caught. If the board of directors of a company minute a decision in their meeting to make a loan to an employee, they arguably at that point create an 'understanding' and become 'third parties' and they either 'earmark' their own funds within Part 7A at the point of making the decision, or they pay a sum within section 554C when they subsequently advance the loan. When shareholders approve new share plans and awards involving treasury shares or shares held in trust, they are arguably 'third parties' who are 'earmarking' shares under 'arrangements' etc. We do not think it is sufficient that HMRC may publish guidance to clarify this aspect as employers will be left in doubt as to the meaning that may be ascribed by the courts in due course.

The earmarking charge

26. Section 554B introduces the earmarking charge. This is far too widely drafted, as will be seen from the examples below.

Share plans

27. A very large number of employers, including many of the largest listed companies, have some form of 'deferred' bonus and/or long term incentive share plan that involves 'earmarking' cash or shares on an award date but delivering the cash or shares only after a vesting period, typically a period of three to five years. FSA guidelines published in December 2010 will of course increase the pressure on employers in the financial sector to provide deferred and conditional remuneration.

28. Employers and employees will not wish to pay tax at the outset in respect of awards that will vest only if conditions are met over a number of following years. The upheaval that will be caused in restructuring employment remuneration packages throughout business in order to avoid the 'earmarking' charges from April 2011 will be disproportionate to the mischief at which this legislation is aimed. In the event that this legislation is enacted in this form, the legitimate expectations of taxpayers need to be preserved. There is insufficient time between now and the proposed start date of 5 April 2011 for those affected to consider the necessary policy changes and take action.

Pension plans

29. 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. 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 (section 595 ICTA 1988).

30. Any such employer with assignees to the UK who have participated in such plans must now consider not only those currently here on assignment but also every individual who has at any time in the past been assigned to the UK and who is still alive. Such individuals will have accrued investments in the home country/international plan while on secondment to the UK and those investments may increase in value (by the receipt of investment income or gains or simply from currency movements) from one month to the next. Each increase in value appears to represents an 'earmarking' which triggers a PAYE/NIC liability. Even those who have retired and are now receiving a pension are not necessarily excluded. 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. Thus far no guidance has been issued on whether ESC A10 may apply to any lump sum caught by Part 7A. If, following the principle that no employee should enjoy any tax advantage beyond those available in registered plans, it is not to apply, taxable lump sums which would previously have been exempted must now be identified and taxed.

31. In any event, the 'earmarking' charge arising from the investment returns is prima facie not itself 'pension' income and so is not exempt. Therefore the past records covering potentially many thousands of individuals worldwide will need to be consulted, taxable values calculated and PAYE/NIC charges paid with effect from 6 April 2011.

32. Where an employee has at any time in the past contributed to such an international pension plan, the trustees of the scheme will be 'connected' to the employee (section 554I(9)(a)) and therefore a 'relevant linked person'. Employer contributions made to the plan since 9 December 2010 will therefore be caught (paragraph 48 of Schedule 1). If the employee wishes to avoid the PAYE charge arising from the deemed payment on 6 April 2012 he will normally have to find the cash to reimburse the employer from his own resources because the pension plan in question is likely to preclude any distribution or application of its funds in this way before retirement.

33. Paragraph 33 of Schedule 1 provides a limit on amounts of relevant benefits taxable under Part 7A. Paragraph 33(4) has the effect of eliminating any express deduction for employee contributions. The result appears to be that if an employee receives a lump sum that comprises a refund of his own contributions and any combination of investment returns on those contributions (that may or may not be considered a commercial return), a lump sum benefit derived from employer contributions, and so on, the payment will represent 'wholly or partly' reward or recognition and will be wholly taxable.

Group employers and advance funding and budgeting

34. In many large businesses, and in government, employees may be contractually employed by one entity but their salaries, bonuses, benefits, etc may be budgeted for, funded, administered and paid by other entities (parent companies, payroll agencies and so on). There are potentially many complex permutations that may give rise to salaries or other components of remuneration packages being 'earmarked' by a third party before they are paid.

35. The task of simply researching the facts in a large organisation may be considerable. Has any research been undertaken within government to establish the extent to which any part of the pay or benefits of, for example, NHS staff, the military, the police et al is affected by this legislation?

Exemptions in Part 7A

36. These are discussed below.

Tax approved plans

37. Section 554E provides exemptions for steps taken 'under' various tax approved plans. This does not go far enough to be effective. Steps taken in order to enable a plan to be adopted and approved are not exempt. If trustees buy shares from an existing shareholder in order to grant CSOP options to particular employees, that purchase is a 'step' and it is not taken 'under' the CSOP. The shares may be taxed under the earmarking charge.

38. Similarly, section 554E(1)(d) provides exemption for a step if it 'for the sole purpose' of granting an EMI option. It is common in practice for employee benefit trusts to buy shares from retiring founder shareholders with a view to granting EMI options to new management. Since the transaction results in shareholders receiving cash originating from the company subject to capital gains tax, a clearance procedure is available, and is often used, under the transactions in securities legislation. Even where such clearances are obtained, the employer will have no certainty. The purchase is a 'step' which is partly to enable the retiring shareholder to leave and sell his shares and partly to grant the EMI option. As it is not 'solely' to grant an EMI option, it is not exempt from a charge under Part 7A.

Loans

39. 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' (section 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.

40. 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.

Employee benefit packages

41. 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 are normally confined to management grades, for example. Administration of benefit schemes are often outsourced to leasing companies, 'flexible benefit' providers and so on. If the employer has an arrangement with a leasing company to provide say company cars only to employees above a certain grade, the allocation of a car will give rise to an immediate PAYE/NIC liability on the value of the car (section 554G(5) and (6)) even though the employee may actually enjoy only the use of a car for a period.

42. We understand that it was not intended that the employee benefit package exemption should be capable of applying to any form of retirement benefit plan. This is on the basis that the basic principle for pensions is that HMRC do not wish to permit any employee from receiving any greater tax advantage in relation to pensions than is possible under the registered pension plan regime. The legislation does not appear to achieve that as the payment of a pension is clearly a 'transaction' with the employee within section 554G(1)(a) and all funding of the pension will be 'steps' taken for the purpose of that transaction. Even if the exemption does apply, as the exemption stands it will be of limited value to employers with pension plans caught by Part 7A (as international plans will often not be available to most of the contractual employees of the employer, or will be confined to higher paid employees).

43. The exemptions in respect of employment related securities are too narrow. Section 554H provides an exemption for an acquisition by an employee of forfeitable securities, or of an option, but it does not exempt an acquisition by an employee benefit trust for the purpose of making the award. The trustees will almost inevitably ‘earmark’ the shares before making the award. Also, section 554H 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.

The value of the ‘step’

44. Section 554K provides that if the step involves a sum of money or an asset the taxable value is the sum or the market value (or, in the case of an asset, the cost if higher). However, for this purpose the cost may be apportioned between the provision of the benefit and other matters. The sum of money and the market value of the asset are not capable of apportionment in this way.

45. Thus suppose a holiday company charters a passenger aircraft with a market value of £20m for two weeks to take fee paying customers on holiday, but permits an employee to take an otherwise unused seat on the aircraft for his holiday. The airline is a third party and takes the ‘step’ of providing use of the aircraft to the employee. The employee is to be taxed on £20m.

Dividends

46. Section 554J(2) provides that dividends paid to employees which are capable of being taxed under Part 7A will be so charged in priority to the normal dividend rules in ITTOIA 2005. Prima facie all dividends paid on shares which are provided to employees under any form of share plan (including any form of tax approved plan) will be caught by this rule, since the plans in question are clearly a form of ‘recognition or reward’ and the rights of share ownership, including the potential to receive dividends, is part of the offer made under the share plan.

47. Given the extremely wide ranging language of section 554A and all of the things that ‘do not matter’, and that dividends will always be voted on by shareholders (ie, third parties), and that the voting on resolutions at shareholder meetings are prima facie ‘arrangements’ it is arguable that any dividend paid to any employee shareholder will be liable to PAYE/NIC. Again, the doubt in this area will be very damaging to business even if HMRC attempt to limit the damage through publishing guidance.

Consideration given by employee

48. Section 554O permits payments made by the employee to be deducted from amounts otherwise taxable under Part 7A. Again this is far too narrow:

- The requirement that the employee’s consideration must be in cash is wrong in principle. If an employee gives consideration in another form (for example on a share for share exchange on a reorganisation or takeover, or an exchange of an interest in shares for another interest of equal value), that should be equally deductible.

- Similarly the requirement that the cash must be paid before the asset is transferred to the employee is wrong in principle. Many contracts involve simultaneous provision of consideration in both directions and it will be impossible to demonstrate that the employee’s payment is made ‘before’ the transfer. Even if the employee’s payment is made after the transfer (for example, in accordance with the rules for settlement on a market, or by means of deduction through the payroll in the following payroll run), he should not be penalised by a tax charge which allows no credit for his payment.

- The deduction is permissible only from a charge arising under section 554C(1)(b). An employee's payment for any 'step' in Part 7A should be creditable against that step.

Imposition of section 222 ITEPA

49. The extension of section 222 ITEPA, itself a tax charge in the nature of a penalty, to the penal charges made under Part 7A, further compounds the problem. The recent appeal in *Chilcott and others v Commissioners for HM Revenue and Customs* [2010] EWCA Civ 1538 demonstrates that section 222 itself is unfair and in need of reform. The policy in defence of section 222 is that it is there to encourage compliance. There is no policy reason why share option gains, etc should be subject to such intense 'encouragement' measures compared with, say, cash remuneration which is not taxed at the correct time and attracts a penalty at a lower level. Given that Part 7A will itself create far greater injustices for the unwary, the addition of section 222 to those injustices will serve to exacerbate the problem, discourage business from operating in the UK, and bring the tax system into disrepute.

Conclusion

50. We believe that the current structure and fundamental principles underlying Part 7A are wrong. While we understand the wish not to leave scope for abuse, and we would be happy to work with HMRC to identify a set of rules that will be fit for purpose, 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.

51. 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.

52. 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.

53. More importantly, if employers can no longer offer deferred or conditional incentive plans without incurring an immediate tax charge, and if all forms of loan 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.

54. We believe that the basic principle underlying these provisions that all 'steps' are caught, whether motivated by tax avoidance or not, 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.

55. We suggest that in view of the far reaching and potentially damaging consequences of the legislation as drafted, the proposals should be substantially withdrawn. We suggest more serious consideration be given to the fundamental principles underlying this legislation and further consultation undertaken on a more workable and realistic structure, which clearly targets the abuses that HMRC wishes to stop but which does not impose additional burdens and cost on UK businesses.

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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.