Disguised Remuneration and the Loan Charge

The taxation of income paid through a third party

1st Edition

David Pett

1. Introduction and background

1.1 Introduction

1.1.1 Purpose of this work

This work seeks to explain the practical application of a body of tax legislation first enacted in 2011 as ITEPA 2003, Pt. 7A and since amended, re-enacted, or added to in 2013, 2014, 2016, 2017 (twice) 2018 and 2020. Part 1 of this book explains the provisions of Pt. 7A, and Part 2 focuses upon the "one-off" 2019 loan charge and its consequences.

Part 7A was intended:

> "to protect the Exchequer … by tackling arrangements used for the purposes of disguising remuneration in order to avoid or defer tax or NICs … or to save beyond the annual and lifetime allowances in registered pension schemes."

The formal heading to the original legislation is "Employment income provided through third parties". However, this is misleading, as the legislation (widely referred to as "the disguised remuneration rules") can give rise to charges to income tax and NICs even if no employment income (or benefit-in-kind) is received by either the employee, director or other office-holder or any relation or other person at their behest. It also extends to directors who have a material interest in a close company, and to individual self-employed contractors. The House of Lords reported that the legislation is "extremely complex and beyond the scope of most business people to decide whether or not it applies to them". It is hoped that this work goes some way to explaining the disguised remuneration (DR) rules to professional advisers who have some general knowledge of tax laws.

1.1.2 Background to the legislation

Since the early 1990s, certain tax silks (i.e. Queen's Counsel) had given opinions on the basis of which some tax advisers had been encouraging their clients to enter into trust-based arrangements whereby – instead of receiving payments of salary or bonus subject to NICs and PAYE deductions – employees and others providing personal services through agencies, personal service companies, so-called umbrella companies or other intermediaries would be advanced money by way of loans. In this way (so it was represented) it was possible to avoid liability for employers' secondary Class 1 NICs and any obligation to deduct tax under PAYE. Such loans were typically made on terms that, whether expressed in writing or otherwise, they were not expected to be repaid until after the death of the borrower, if ever.

Where such opinions indicated that consideration given for the provision of services as an employee could avoid PAYE and NICs by being paid in the form of a loan from a third party, they were – as many advisers had concluded at an early stage, and the Supreme Court ultimately confirmed in 2017 in the *Glasgow Rangers* case (see below) – simply wrong.

Nevertheless, an entire "industry" of advisers, offering substantial savings to employers, intermediaries and (later) self-employed independent contractors, quickly appeared on the basis that such arrangements were (they asserted) effective to avoid tax and, having been disclosed to HMRC, were not then being challenged. Many such arrangements were intended to enable the company funding such advances to deduct the amounts expended in computing their liability to corporation tax.

To the author's knowledge, HMRC were fully aware of loans by employees' trusts to avoid PAYE tax and NICs. Nevertheless, apart from focusing on successfully challenging claims to CT deductions, HMRC showed a marked reluctance to take action to address the loss of income tax and NICs on what were, on any reasoned basis and as a matter of common sense, properly to be treated as amounts earned for work done. It was not until 2011 that, having first announced on 9 December 2010 its intention to curb such avoidance, the government produced draft legislation (included in *Finance Bill* 2011 published on 31 March 2011), to take effect from 6 April 2011 (or, in relation to loans made after 9 December 2010 and before 6 April 2011 but not repaid before 6 April 2012, so as to give rise to a charge on 6 April 2012).

It was estimated by the House of Lords[1] that the loss to the Exchequer from such known tax avoidance schemes in 2008-09 was in the region of £1.1 billion and, in the absence of action being taken, would rise to an estimated £1.54 billion in 2011-12. In reality, and with hindsight, it is likely that these figures were a substantial underestimate of the real loss to the Exchequer. That report criticised HMRC for not having acted sooner to curb such losses and stated that "there was clearly a very wide and deep unhappiness with this draft legislation".

---

1 in its Economic Affairs Committee 4th Report on the *Finance Bill* 2011

Of course, action should have been taken earlier. It would have been relatively straightforward to impose an obligation on any employer (or person engaging personal services to be provided by an individual) who paid away money or other assets to a third party by way of contribution to a trust (or otherwise), to deposit with HMRC an amount representing tax at, say, 53.8% (40% + 13.8%). Credit for such amount could then have been given against PAYE tax and employers' NICs if and when such sums were applied in the provision of taxable benefits. However, as reported to the author by HMRC officials, ministers were anxious that the new charges should not be perceived as an additional tax on business. For that reason, it was said, the DR rules had to be structured so as to impose a charge on the employee, albeit one for which the employer is primarily liable to account under PAYE. This has resulted in a new order of complexity.

Whilst HMRC did consult on the drafting of the DR rules, and they were amended to avoid penal charges arising in certain limited situations, in most of which a liability to income tax was already imposed, there is no general exclusion of what might be considered to be *bona fide* commercial arrangements having no tax avoidance purpose. So, for example, a long-standing arrangement under which annual profit-sharing bonuses of employees of a bank were paid into a trust and used to acquire shares in the bank which were then "earmarked" for the individual employees pending their retirement, was found to be caught: a charge to income tax and NICs arising upon the initial earmarking rather than the later receipt of the proceeds of sale of the shares when the employee retired.

There is no statutory clearance procedure. In an employment situation, the onus is on the employer to account for tax and NICs under PAYE and for the employee to self-assess any liability to tax under the DR rules, under threat of penalty and interest for failure to do so.

Case: *RFC 2012 Plc (in liquidation) (formerly The Rangers Football Club Plc) v Advocate General for Scotland (Scotland*)[2012] UKSC 45

1.2 The scheme of the DR legislation

1.2.1 The main case

The DR rules as they relate to employments (including directorships and other offices), referred to as "the main case", are set out in ITEPA 2003, Pt. 7A.

For a DR charge to arise under the main case there has to be an arrangement relating to an existing, past, or future employment of a person (A) with an employer (B). If there is no employment relationship, a DR charge may still arise by virtue of the "close companies" case, if the individual concerned is or has been a director and has a material interest in the company (see **Chapter 4**), which forms part of Pt. 7A.

A liability to income tax and NICs arises under the main case if:

- it is reasonable to suppose that, in essence, that arrangement is a means of providing, or is concerned with the provision of, rewards or recognition or loans in connection with A's office or employment with B;
- a "relevant step" is taken by a "relevant third person"; and
- it is reasonable to suppose that, in essence, the step was in pursuance of the arrangement or there was some other connection between them[2].

The charge under both the main case and the close companies case (below) is imposed by s. 554Z2, which treats the value of the relevant step as counting as employment income of A (see **8.1**). Sections 554E to 554Y set out a series of exclusions from the charge. These are considered in **Chapters 5** to **7**. Sections 554Z4 to 554Z14 make provision for the charge to be reduced, or for credit to be given against that or earlier charges for tax paid on a DR charge, in various circumstances.

Further provisions, in sections 554Z16 to 554Z21, impose charges on the earmarking by an employer (B) of a sum or assets, or the provision by B of security, for the performance of undertakings in relation to the provision of retirement benefits (see **Chapter 12**).

1.2.2 The close companies case

It later became apparent that, in relation to owner-managed businesses, advisers were seeking to sidestep the charging provisions of the main case by asserting that the provision of benefit by a third party was not "in essence" a means to provide rewards, recognition or loans in connection with an office or employment, but was instead an

[2] So, for example, in *Root 2 Tax Limited v HMRC* [2019] UK FTT 744 (TC), the FTT determined that payment of spread-betting winnings to an employee was in pursuance of an arrangement made by the employer with a relevant third person, although the return of the stake first paid by the employee was not, as the tenor of the DR regime is "to capture sums which are in reality paid by way of economic gain as disguised employment earnings".

arrangement for the provision of shareholder benefits not connected to an individual's office or employment with the company. This was addressed by the addition, with effect in relation to steps taken on or after 6 April 2018, of sections 554AA to 554AF, known as the "close companies case", which imposes charges if (to paraphrase):

- there is an arrangement to which an individual (A) is a party, or which relates to A, and it is reasonable to suppose that, in essence, it is a means of providing (or is concerned with) payments, benefits or loans provided to A or to persons linked to A;
- a close company of which A is, or has within the past three years been, a director or employee *and* has, or had within the past three years, a material interest (B), enters into a relevant transaction;
- it is reasonable to suppose that in essence this was in pursuance of, or connected with, the arrangement;
- a "relevant step" is taken by a "relevant third party";
- it is reasonable to suppose that the sum or asset which is the subject of the relevant step represents or has arisen from that which was the subject of the relevant transaction (or vice versa); and
- in or around or between the times of the relevant transaction and the relevant step, a main purpose of the arrangement is the avoidance of either a charge to income tax, NICs or corporation tax or a charge under the "loans to participators" rules in CTA 2010, s. 455.

See **Chapter 4**.

References to the DR rules include both the main case and the close companies case.

The legislation governing the one-off loan charge, which arose on 5 April 2019, also forms part of the DR rules although it is set out in F(No. 2)A 2017, Sch. 11 (as amended) and has not been consolidated into ITEPA 2003, Pt. 7A. The loan charge is outlined at **1.4** below and described in more detail in **Part 2**.

1.2.3 Trading income through third parties

Similar, although less extensive, rules were introduced by F(No. 2)A 2017, s. 35 as new sections 23A-23F of ITTOIA 2005 under the heading