DEXTRA – ITS NOT OVER TILL THE FAT LADY SINGS AND OTHER CLICHÉS

by Patrick Way

Introduction

The House of Lords has dismissed the taxpayers' appeal in *Dextra* (*MacDonald v. Dextra Accessories Ltd & Others* [2005] STC 1111) and has held, broadly speaking, that no tax deduction is allowed to an employer who contributed to an employee benefit trust ("EBT"), before 27th November 2002, until emoluments (which does not include benefits in kind) are paid out by the EBT trustees. So, as far as the Revenue are concerned, given that they lost before the Special Commissioners and Neuberger J in the High Court, it was worth their while "waiting for the fat lady to sing" (Cliché No.1): the Lords' judgment is very clearly in their favour.

A summary of the issues

Dextra and other companies in the Caudwell Group of Companies together paid a sum of £2.75m to an EBT trustee resident in Jersey. The payment took place on 21st December 1998 and the issue was the time when the paying companies could deduct those payments. More particularly, did they have to wait until a relevant emolument was paid or, as Dextra argued, was there an "immediate" deduction in the year in which the payment was made to the EBT (year end 31st December 1998)? The Special Commissioners had previously held that when the EBT trustee had set aside trust funds into "earmarked" sub-funds, this earmarking did not amount to the payment of an emolument. They had also decided that the ratio in *Ramsay* had no application in the situation under review. Since the sub-fund and *Ramsay* points were not taken forward to later hearings, the only issue for the House of Lords in *Dextra* was as to the time of deduction.

Dextra had earlier conceded that the EBT trustee was an intermediary although it is not clear on what basis this concession happened. This was a big point, and meant that both sides accepted that the provisions of s.43 Finance Act 1989 (as they applied at the relevant time) were in point. Section 43(11) of the Finance Act 1989 stated that, in effect, potential emoluments are paid when they become relevant emoluments which are paid, and until then no deduction occurs. The definition of "potential emoluments" is as follows:-

> "Amounts or benefits reserved in the accounts of an employer, or held by an intermediary, with a view to their becoming relevant emoluments."

The "sixty four thousand dollar question" (Cliché No.2) was, its having being conceded that the EBT trustee was an intermediary, whether the trustee held the payments with a view to their becoming relevant emoluments.

In a very brief judgment the House of Lords held that, in the ordinary use of language, the whole of the funds paid to the trustee were potential emoluments because they *could* be used to pay emoluments. More particularly, the amounts held by the trustee as intermediary were for the payment of emoluments upon a contingency, namely the exercise of the discretion by the trustee. The sums might or might not be used to pay emoluments, but there was at least a realistic possibility that they would be. Lord Hoffmann thought that if this judgment gave rise to any unfairness then "*any untoward consequences can be avoided by segregating the funds held on trust to pay emoluments from funds held to benefit employees in other ways*." This is an important "aside" to which I return later. It would have been interesting to see the outcome had it been argued that the trustees were not intermediaries, after all; although I doubt this would have made much difference, given the force of the Lords' judgment.

The legislation

Section 43 Finance Act 1989 (as was) reads as follows:-

> "(1) Subsection (2) below applies where-
>
> (a) A calculation is made of profits or gains which are to be charged under Schedule D and are for a period of account ending after 5th April 1989,
>
> (b) Relevant emoluments would (apart from that subsection) be deducted in making the calculation, and
>
> (c) The emoluments are not paid before the end of the period of nine months beginning with the end of that period of account.
>
> (2) The emoluments-
>
> (a) Shall not be deducted in making the calculation mentioned in subsection (1)(a) above, but
>
> (b) Shall be deducted in calculating profits or gains which are to be charged under Schedule D and are for the period of account in which the emoluments are paid
>
> …
>
> (10) For the purposes of this section "relevant emoluments" are emoluments for a period after 5th April 1989 allocated either –
>
> (a) In respect of particular offices or employments (or both), or
>
> (b) Generally in respect of offices or employments (or both).
>
> (11) This section applies in relation to potential emoluments as it applies in relation to relevant emoluments, and for this purpose-
>
> (a) Potential emoluments are amounts or benefits reserved in the accounts of an employer, or **held by an intermediary, with a view to their becoming relevant emoluments**;

> (b) Potential emoluments are paid when they become relevant emoluments which are paid."

There are more questions than answers (Cliché No.3)

The *Dextra* case is somewhat unsatisfactory. It does not seem likely, to me at least, that when "the powers that be" (Cliché No.4) decided that EBTs were "a good thing" (Cliché No.5) they would have held s.43 in reserve to deny an immediate deduction. This would have rendered EBTs most unattractive. And yet they were intended to be utilised fully. Indeed, it is my recollection that in the early days the Inland Revenue conceded that s.43 would not be invoked by them in relation to payments into EBTs, but at some time this concession was withdrawn. EBTs were particularly useful in the early 1980s – in the days before share buybacks were allowed as a matter of company law, because they enabled proprietors of companies to set aside portions of the company's money which could be used to acquire shares from those proprietors on retirement, thus preventing the company from falling into outside ownership. But the absence of an immediate deduction would have made EBTs most unattractive, and my understanding is that it was typically given.

On the other hand, it would never have been contemplated, when EBTs were first utilised, that they would become such a regular feature of extravagant avoidance. In the *Dextra* case, it is understood that there were loans to employees running into tens of millions of pounds each, and it is therefore easy to see why the Inland Revenue, and ultimately the House of Lords, found it unacceptable, in this sort of situation, to afford a sponsoring company an immediate deduction, in circumstances where there was no "matching" charge to tax in the hands of the employees. That would be to "rub salt into the wound" (Cliché No.6).

So, let us examine some of the questions that remain following the judgment of the House of Lords.

Question 1

The first question is whether it can be said that all EBT trustees, in all situations, are intermediaries. After all, one of the key concessions throughout the various stages of the *Dextra* litigation (apart from the House of Lords) was that it was accepted that the *Dextra* trustee was an intermediary: see the Special Commissioners' decision [2002] STC (SCD) 413 at para.6, and the judgment of Neuberger J in the High Court where he said:-

> "[Counsel] who appears for the Respondents accepts, in my view rightly, that the contributions were "held by an intermediary" namely the trustee." [2002] STC 749 [17]

And see the Court of Appeal judgment, where Jonathan Parker LJ said:-

> "It is rightly accepted that the trustee of the EBT is an "intermediary" for this purpose so the issue boils down [*I wouldn't dare call that a cliché*!] to whether the contributions were held by the trustee "with a view to their becoming relevant emoluments". [2004] STC 339 [62]

Perversely, it seems that it may be, after all, that in the House of Lords it was not conceded that the trustee in *Dextra* was an intermediary, but there is no mention of this in the judgment. So presumably their Lordships though it obvious that the trustee was an intermediary, and the point was not worth pursuing.

So, reverting to the question, "are all EBT trustees intermediaries in all situations?", the answer must be "yes" given the way that the *Dextra* case has gone. But this does strike me as odd. There is no statutory definition of the expression for these purposes. (There is a PAYE definition, but this has no application to s.43.) Further, an intermediary is someone who acts as a go-between (between the employer and the employee in this context) and the whole point about trusts (as I remember them from my days as a solicitor in Lincoln's Inn) is that settlors and trustees are quite separate. I remember having to warn potential settlors again and again that once they had given away their assets to trustees they were at the mercy of the trustees, albeit by reference to the terms of the trust document and to the laws concerning trusts. And if settlors were worried about their lack of control, then trusts were not for them. So I for one am a little surprised that EBT trustees are intermediaries. Were it not for the judgment in *Dextra*, I would be of the view that they were not. However, any attempt, from now on, to argue that particular trustees of a particular EBT are not intermediaries on the facts is probably something of "a dead duck" (Cliché No.7).

Question 2

The next question concerns the relevance of accounting principles and standards. It is understood that the Inland Revenue had in reserve another EBT case, in which they were going to run the argument that various accounting standards – including in particular UITF 32 – supported their argument, that assets comprised within an EBT should, as a matter of prudence, be treated, in effect, as assets remaining under the ownership of the employer. So there should be no deduction because the assets in effect "continued to belong to that employer". Indeed, I understand that counsel for the Inland Revenue in *Dextra* made a very persuasive argument before the Lords in relation to accounting standards, which is not reported, but which presumably had some effect (albeit indirect) on the outcome. I imagine that there will now be no need for a case concerning accounting standards to proceed, given that the Inland Revenue have won *Dextra* without having to resort to their contentions on this point. Nevertheless, it would have been interesting to have seen the arguments rehearsed. The Inland Revenue have always maintained that their position is supported by accounting treatment, and used to refer first to UTIF 13 (which was hopeless) and then to UTIF 32 (which was not relevant provided that the trustees were in effect acting independently from the employer):-

> *The sponsoring entity does not have control of the rights or other access to the future economic benefits it is expected to receive. This will involve evidence that the payments are made by the intermediary and not habitually made in a way that is in accordance with the sponsoring entity's wishes*

To be fair to the Inland Revenue, there is plenty of assistance for their point of view from those of expert auditors, and typically the Inland Revenue quote the following from a publication written by such an expert:-

> "If the directors of a company gave £1m to a trust in the genuine belief that they have no influence over what happens to that money, they are arguably in breach of their fiduciary duties no less than if they draw £1m. out of the bank in used notes and leave them in the street with a sign saying "Please take one". In reality, the directors make donations in the near certain belief that the trustees will dispose of the assets according to the company's wishes."

I simply do not agree with the above. Trustees are independent from the settlor and settlors take risks, when they set up trusts, that this independence may produce unwelcome results. Settlors have to accept that they relinquish control of trust assets, but trustees are not able to give away trust assets in a cavalier fashion, as the extract above suggests: they are, after all, governed by the terms of the trust instrument and the rules of equity. Anyway, it strikes me as wrong to say that, as a matter of *prudent accounting*, the assets of an EBT should always be included as assets of the sponsoring company. Assume, for example, that a company has transferred £10m. into an EBT but has no money of its own. A creditor would be seriously prejudiced if he assumed (by reference to GAAP) that the company had £10m. to meet its debts. It simply does not. So to adopt an accounting principle to say that the £10m effectively belongs to the company is thoroughly misleading, possibly negligent. Or, assume that a company has transferred significant sums into an EBT which have been used to acquire some of the sponsoring company's shares from the previous shareholders – such that, say, 75% of the company is now owned by the EBT. Does anyone seriously believe that in this situation, where the EBT is the 75% holder of the sponsoring company, nevertheless, the EBTs assets remain under the control of the company? This is patent nonsense. However, it is unlikely that this area will ever be tested because, of course, the Inland Revenue have won *Dextra*, and – presumably – do not need to refer to accounting principles again in this area of tax law.

Question No.3

The next question is what one can do in relation to contributions that were made before the 27th November 2002. And here there seems to be "manna from heaven" (Cliché No.8) in Lord Hoffmann's judgment. He says, first at paragraph [12]:-

> "There is no dispute that on ordinary accounting principles the [contribution] was deductible in computing the profits of the taxpayer companies in [the relevant year] save for the provisions of s.43(11)(a)."

He then (at paragraph [20]) goes on to say, in effect, that he is aware that the judgment of the House of Lords (to the effect that there is no immediate deduction) may produce an anomaly and an unfairness. He then makes the following very telling comment:-

> "The anomaly and unfairness has not troubled Parliament [in 2003] and may not have troubled the Parliament of 1989. As Jonathan Parker LJ observed [in the Court of Appeal], it is the result of an arrangement into which the taxpayers have chosen to enter. **Any untoward consequences can be avoided by segregating the funds held on trust to pay emoluments from funds held to benefit employees in other ways**."

These words in bold are "dynamite" (cliché No.9). On the face of it, it would seem that it is not too late now to make this segregation into funds that can produce emoluments and those that cannot. This (second) segregated fund, comprising – say – future benefits in kind to be made to employees or sums to discharge costs, may perhaps then (it seems to me) be outside the ambit of the old s.43(11)(a), because it is not capable of producing potential emoluments. As such it then seems that there should be a deduction, for the accounting period in which the segregation takes place, in relation to this second fund. Anybody wishing to do so this should think carefully about the commercial consequences of irrevocably stating that funds will not be utilised for emoluments, but on the face of it this may be an appropriate step to take.

An alternative, of course, is to pay emoluments out now, and thereby trigger a deduction for the accounting period in which the emoluments are paid, and current planning now revolves around trying to pay these emoluments in circumstances where a deduction is allowed in full, but where – for whatever reason – the emoluments are reduced in size, with the resulting taxation in the hands of the employee also being reduced.

Question 4

Question 4 has to do with the position concerning contributions made into EBTs on or after 27th November 2002. Following the earlier judgments in *Dextra* (when the Inland Revenue lost), the Inland Revenue reacted by changing s.43 and introducing Schedule 24 Finance Act 2003. It is sometimes overlooked, therefore, that s.43 (in a truncated form) still exists and should be carefully considered for contributions made after 26th November 2002. The effect of "the new s.43" can be avoided if the contributions do not appear in the accounts of the company as a deduction in respect of employees' remuneration. It is then necessary to circumvent the provisions in Schedule 24 Finance Act 2003, and a number of different methods have been put up some of which seem to be more satisfactory than others. So all may not be lost, particularly for those determined to utilise EBTs and to obtain an immediate deduction.

Conclusion

So, in the end, *Dextra* has been and gone, and the position remains rather unsatisfactory. It would have been helpful to have had more discussion on the subject of intermediaries and on accounting standards, but instead, as is the modern way, the opinion of the House of Lords is rather terse and without much explanation.

Notwithstanding all this, I very much doubt that EBTs are dead. So "watch this space" (final cliché).