FINANCE (NO 3) BILL 2011 – EMPLOYMENT INCOME PAID THROUGH THIRD PARTIES

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INTRODUCTION

The proposed new legislation taxing employment income through third parties is in the form of a consultative draft (supplemented with a FAQs memorandum of 21 February 2011 and a warning ("a score tactic") Spotlight 11 of 3rd March 2011) and it has its sights on employee benefit trusts (EBTS) and employer funded retirement benefit schemes (EFURBS).

The proposed new legislation is contained in a new Part 7A which is to be inserted into ITEPA 2003.

OUTLINE OF THE NEW CHARGE

In general, the new Part 7A seeks to tax benefits arising to employees and persons connected with employees if the employer uses third parties (widely defined) to make over benefits to the employees or persons connected with the employees.

APPLYING THE NEW CHARGE

When applying the new employment income charge provisions one must look at the following:-

1. The ambit of the new legislation;
2. The relevant steps which need to be satisfied before a charge can arise assuming one is within the ambit of the provision;
3. The quantum of the charge if one is caught by the legislation;
4. The exclusions and reliefs (few and far between though they be) from the charge; and
5. The all-important commencement and transitional provisions.

AMBIT

To fall within the ambit of this legislation there must be a person (described as A) who is an employee or former employee or prospective employee of another person who is the employer. The employer is called B.

There must be an arrangement (called the "relevant arrangement") and this must relate to A (the employee). It must be reasonable to suppose that in essence the relevant arrangement is concerned with the provision of rewards or recognition or loans in connection with A's employment or former or prospective employment with B.

There must thus be an employment nexus. These provisions are wholly irrelevant to non-employment situations. Thus, if an individual sets up and funds his own pension scheme these provisions are wholly irrelevant. If a fund is set up to help self-employed persons the provisions are wholly irrelevant.

It is clear from the above that, if an employer sets up an EBT for A and other employees, one comes within the ambit of the provision: there is an arrangement which relates to A. The EBT is to provide rewards or loans to persons including A. The structure relates to the employment of A.

THERE MUST BE A RELEVANT STEP

Connection between "relevant arrangement" and "relevant step" and "relevant third party"

Assuming a structure is within the ambit of the provision (because there is, inter alia, a relevant arrangement) there can only be a charge if there is a relevant step carried out by a relevant third party and it is reasonable to suppose that in essence the relevant step is taken in pursuance of the relevant arrangement or there is some other connection (direct or indirect) between the relevant step and the relevant arrangement.

Thus one has to first identify the relevant arrangement and a step is a relevant step only if it is reasonable to suppose that in essence the relevant step is carried out in pursuance of the relevant arrangement. So if an EBT structure is set up, that would be the relevant arrangement. If the EBT, for example, under the terms of the EBT document, lends money to an employee that will be a step which is a relevant step as it is reasonable to suppose that in essence that step of lending the money is done in pursuance of the relevant arrangement comprising the EBT and its terms and the monies put into it.

The legislation refers to a relevant third party as taking the relevant step. If there is no relevant third party the legislation cannot apply. Relevant third party is very widely defined and includes any person as well as the employer (or employee) if the employer (or employee) holds money or assets for the purposes of the arrangement or is responsible for the management of any money or assets held under the arrangement (s.554A(b)). The width of the final legislation, however, may be narrowed down – see FAQ6.

Relevant third party is thus very widely defined. If the employer makes a loan to the employee the new legislation can apply.

First Relevant Step (Earmarking)

A person (the legislation calls that person P) takes a relevant step (which causes a tax charge) if P earmarks (however informally) any sum of money or assets held by or on behalf of P with a view to a later relevant step (e.g. a loan being made) being taken.

There can be an earmarking even though, for example, one has not worked out the details of the sum or asset which would be the subject matter of the subsequent step or details of how or when or by whom or in whose favour the step will be taken.

If monies are thus settled by a company into an EBT and there are, say, 100 employees and the funds are not earmarked for any particular employee then there will be no relevant step. There is no earmarking.

If the EBT creates a sub-fund for employee A and his family, there clearly will be an earmarking.

HMRC often argue that a fund set up for 100 employees may really be earmarked to benefit, say, 6 employees: if there is evidence to that effect then there could be an immediate charge.

However, if the funds are not earmarked, there would be no difficulty with regards to this head. In cases where the trustees determine that assets shall be held in various proportions for employees without giving the employees any legal rights to the same and without creating formal sub-funds there could be an earmarking.

Another area to avoid is the directors of the company determining what employees should get what and then transferring funds to the EBT – with their suggestions. The earlier earmarking by the company may create a problem though it is difficult to see how this legislation applies if the funds go to the EBT and the EBT determines that the funds shall go to persons other than the persons earmarked by the company. This legislation works well if the earmarked employees actually receive the funds subsequently by way of loan or outright transfer but not if the funds are earmarked for one person and another person receives them.

This tends to indicate that earmarking needs to be something fairly firm.

It should be noted that this legislation is concerned with identifying the relevant employee – referred to as A. The employee (A) is deemed to include any person linked to A. Section 554I(9) states that a person linked is to A if:

> (head 1) that person is connected with A; or
>
> (head 2) that person is a close company in which A (or a person within any of the other heads) is or has been a participator; or

(head 3) is a company which A (or a person within any of the other heads) is or has been a participator and which would be a close company if it were a UK resident company; or

(head 4) is a company which is a 51% subsidiary of a company within the last two heads (head 2 and head 3).

"Connected" is defined in ITEPA 2003 s.718 and ITA 2007 s.993 and s.994 and this would include a spouse of A and a relative of A (brother, sister, ancestor or lineal descendant). A widow and widower is not included in the section but a linked person includes any person who is or was connected to A and a widow was connected with A when she was his spouse.

A man and woman living together as if they were spouses of each other are treated as spouses. The same applies to people of the same sex living together (s.554I(10)) and ITA 2007 s.993).

Second Relevant Step (Payment of Sums and Transfers of Assets)

A person (P) takes a relevant step if:

(a) a sum of money is paid to a "relevant person" (this can include a loan – the full amount of the loan is deemed to be the sum paid: see s.554I(8): the same applies if an employee raises monies from the EBT by issuing to it a deeply discounted security: the amount raised will be the sum paid).

(b) there is a transfer of the property in an asset to a relevant person by P e.g. a Ming vase is advanced outright by the trustees of an EBT to the employee (s.554C(1)(b)).

(c) steps are taken which enable the relevant person to acquire certain securities and interests is securities and securities options (s.554C(1)(c) and (4)).

(d) P makes available a sum of money or an asset to be used as security for a loan made or to be made to a relevant person or otherwise as security for the meeting of any liability, or the performance of any undertaking, which a relevant person has or will have.

(e) P grants to a relevant person a lease of any premises (landed property) the effective duration of which is likely to exceed 21 years.

For the purposes of this legislation, the "relevant person" is the employee (A) or a person chosen by A or within a class of people chosen by A to get benefits and also other persons if the trustees of the EBT, for example, take steps on A's behalf or otherwise at A's direction or request and benefits those other persons.

References to A also includes any person linked with A (as defined in s.554I(9)).

For example, an EBT on its own volition may transfer funds to a school to pay the fees of the children of A. The transfer is not made to A or a person linked with A and A has not chosen the school to be a person or class or persons who gets the transfer and he has given no directions and made no requests in that respect and the payment is not made on A's behalf (if A had directed or requested the school fees be paid then the transfer will be treated as having been made to A and a charge would arise under s.554C(1)(a) (see s.554C(2)(b)). On the face of it therefore, the provision is avoided. However, it is arguable in that circumstance that there is still a problem because the EBT would have used cash to acquire an asset, which is a "chose in action" namely the right to use the school, and these rights would vest (one may be able to take technical points on the meaning of the word "vest" where infants are involved; see for example TCGA 1992 s.60) in the children; the charge may arise by virtue of s.554C(1)(b); there is a transfer of property in an asset to a relevant person (ITA 2007 s.994(1) – "lineal descendant").

Clearly if a loan is made to an employee there will be charge and this is on the full amount of the money lent.

There are double charge relieving provisions.

If, for example, the EBT earmarked £100,000 for A, that would give rise to a charge. If there was then a loan of £100,000 to A, prima facie, that would give rise to another charge. If the loan was then released there would be another charge. There are relieving provisions to ensure that that does not occur (s.554M overlap with earlier relevant step).

There are also relieving provisions to ensure that if the loan is charged outright on A there cannot be a charge on, say, the annual market value of the same (s.554J(2)(a)).

What does seem to be reasonably clear is if the employee is granted a lease for, say, seven years the lease is a separate asset from the reversion; the physical building is not the relevant asset; the lease is a separate asset in the hands of the employee in its own right. If the rent is a market rent then the value of the asset is negligible. If the employee were, for example, to sell a rack rent lease which was granted to him by the EBT he would not get a premium. The lease as an asset in his hands is worth nil. The reversion has value because of the rental rights but the employee does not get the reversion.

These provisions only apply if the lease is likely to exceed 21 years. Thus if the EBT grants a lease of, say, 22 years (and note there are special provisions deeming shorter term leases to be for over 21 years) then one has to apply this legislation: if a market rent is paid then the value of that asset is negligible and no charge arises (note the point, however, about cost below).

If the lease is for, say, seven years and the facts indicate that the lease will not go for longer than that (because, for example, the EBT itself only has a lease for seven years) and a market rent is charged, it may be argued that the position does not fall within s.554C(1) (the second relevant step at all). If the taxpayer does not come within this section at all then the situation falls to be taxed under the general employment income regime.

The writer takes the view that the seven year lease is an asset and it comes within s.554C(1)(b). If not it will be charged under the general employment income code: in either event, if full rent is paid there are no adverse consequences (subject to the cost point). The exact significance of having a lease which is likely to exceed 21 years being dealt with specifically under s.554C(1)(e) (as opposed to simply being dealt with under s.554C(1)(b)) is not easy to grasp.

The heads in s.554C(1)(a) (money) and s.54C(1)(d) (loan security) are important ones with regards to EBTS. EBTS may have made loans or may have provided facilities enabling loans to be made to employees: subject to the transitional provisions such transactions are outlawed under the new legislation. HMRC do not believe that such loans will ever be repaid and the legislation is drafted on that basis.

The third relevant step (making assets available)

There is a chargeable event if a person (P):-

(i) makes an asset available for a relevant person to benefit from in a way which is substantially similar to the way in which the relevant person would have been able to benefit from the asset had the property been transferred to the relevant person at that time; or

(ii) at or after the "relevant period" P makes the asset available to the relevant person to benefit from.

References to making an asset available are references to making it available in any way, however informal; it does not matter if the relevant person has no legal right to benefit from the asset and nor does it matter if the relevant person does not actually benefit from the asset.

It is felt that the reference to an asset includes land.

This is a particularly penal provision.

If a Ming vase is made available to an employee to enjoy in his house he suffers an employment charge under this legislation in an amount equal to the value of the Ming vase at the time when it was made available to him (or if higher, the amount paid for the Ming vase by the EBT – see s.554K(2)(b) and (5)).

The provision may also have a harsh result, for example if the trust has a freehold property and the trustees allow the employees to live in it. It could be argued that if a licence was granted, that licence would be the asset and the trust transfers the property in the licence to the employee and thus one must value the licence (see s.554C(1)(b)).

Indeed, the safest course may be to grant a lease which is likely to exceed 21 years so that one clearly comes within s.554C(1)(e). One must value the asset i.e. the lease. One will have transferred the property in the lease to the relevant person and thus one does not come within the third head in s.554D.

One of the curious requirements of this head is that the employee who benefits from the asset being made available to him must benefit from it in a way which is substantially similar to the way in which the absolute owner of the asset may have benefitted from the use of the asset. It may be that this requirement was added because the charge is a harsh one and the legislation is looking to situations where in truth and reality the asset would never be returned to the EBT and the employee would enjoy it for all time. It may be that one could avoid the application of this provision if the terms upon which the asset is made available restrict the beneficial user of the same by the employee such that it cannot be said that he will be enjoying it in the same way that a full beneficial owner of the same would enjoy the same.

QUANTUM OF THE CHARGE

The key provision on the quantum of the charge is s.554J(1), which states that one must determine the value of the relevant step and that value counts as employment income of A in respect of A’s employment with B.

It is to be noted that this new legislation overrides the general employment income code where it applies but otherwise the general employment income provisions will apply: this is in accordance with the general tax maxim of “the worst applies first”.

If the relevant step gives rise to a taxable amount which would otherwise have been treated as earnings under the benefits code or otherwise be caught under Chapter 3 of Part 4 ITTOIA 2005 (dividends etc from UK resident companies) then the new Part 7A code takes precedence over the benefits code or any provision in Chapter 3 of Part 4 ITTOIA 2005. Note that generally if employment income also falls within the dividend code the latter takes precedence for income tax purposes (*IRC v PA Holdings Ltd* Upper Tribunal (Finance and Tax) TC00063). However, if the new charge provisions apply they take precedence over the dividend code.

In determining the value of the relevant step if this involves a sum of money the value of the relevant step is the amount of the money (s.554K).

If an EBT makes a loan of £100,000 to A even though the loan has to be repaid on demand, the value of the relevant step is £100,000.

Section 554K2 states that in any other case where sums of money are not involved the value of the relevant step is the market value when the relevant step is taken of the asset which is the subject matter of the relevant step or if higher the cost of the relevant step.

Thus if a piece of antique furniture has a value of £50,000 and this is made available to an employee to enjoy in his home without the furniture being transferred to him outright, and he enjoys it as if he were the absolute owner of the same, he will be chargeable to tax under the new regime (which cancels out any charge under the general employment income regime) as if he had received an emolument of £50,000 unless the cost of the relevant step is higher in which case he will be taxed on the higher value (if the EBT in question had purchased it for £60,000 he would be taxed on £60,000).

The specific provision dealing with the higher of cost and market value is s.554K(5). It states that the reference to the cost of the relevant step is a reference to the expenses incurred in or in connection with the taking of the relevant step (including a proper proportion of any expense relating partly to the relevant step and partly to other matters) by the person or persons at whose cost the relevant step is taken.

If the EBT bought freehold land for £1m and granted a lease to the employee without rent which gave rise to a market value lease in the hands of the employee of £250,000 then the market value of the asset (the lease) would be £250,000 and a proper proportion of the acquisition cost would also be £250,000. The cost and the market value step would be the same.

On the other hand, if a lease was granted to an employee at a rack rent then it may be that the capitalised value of the rent in the hands of the EBT may be £250,000 and the balance of the land interest may have a value of £750,000. By paying a full rent the value of the asset in the hands of the employee would be nil. The question is what part of the £1m acquisition cost must be apportioned to lease? If it is £250,000 then the employee would suffer a charge under the new provisions even though he is paying a rack rent.

It is arguable that a proper proportion of the expense of £1m which relates to the relevant step (the grant of the lease) is nil. The value of the property in the hands of the EBT is unchanged by the grant of the lease. If one were to do a capital gains tax calculation there would be no relevant disposal; no part of the base cost of the freehold would be apportioned to the grant of the lease. On the other hand, it may be argued that part of the acquisition cost of the freehold was incurred in connection with the lease: connection is a word of wide import (*Clarke v IRC* (1976) 2 WLR1). The purchase of the freehold was done in connection with the grant of the lease. On the other hand the freehold is retained. The writer feels it can be properly argued that in the case of a rack lease rent grant no part of the original acquisition cost can properly be apportioned to the lease grant.

Special rules apply to shares (s.554K(3)).

SPECIAL EXEMPTIONS AND RELIEFS

Registered Pension Schemes

The provisions do not apply if the relevant step is taken under a registered pension scheme (s.554E(1)(g)).

QROPS and QNUPS – their fate is awaited

It must be noted that with regard to qualifying registered offshore pension schemes (QROPS) and qualifying non-UK pension schemes (QNUPS) it is provided in s.554E(3) thus:-

> "The Commissioners for Her Majesty's Revenue and Customs may by regulations provide that, in the cases set out in the Regulations, Chapter 2 is not to apply by reason of a relevant step under a relevant non-UK scheme (within the meaning of paragraph 1(5) of Schedule 34 FA 2005."

A relevant non-UK scheme includes a QROP if certain transfers have been made.

It may be that QROPS and QNUPS will have a more generous scheme applied to them (see also s.554K(6), (7) and (9). Practitioners must wait and see.

Commercial Transactions

There are special exclusions for commercial transactions and transactions under employee benefit packages (554F and 554G).

These are unlikely to have much relevance to the normal EBT cases.

Employment Related Securities

Special provisions apply to employment-related securities.

These are in s.554H.

Market Value Sales

Under s.554O, if, for example, an EBT sells an asset to an employee then the amount of the benefit chargeable under this code is reduced by the consideration paid provided the payment is made before the relevant step is taken.

One would have thought the legislation would have stated that the consideration had be paid before or at the same time as the relevant step but practitioners must be aware of that technical point.

Remittance Basis

There are special rules to ensure the remittance basis continues to be available in appropriate cases though it is possible in such cases that the taxpayers would not have wanted the funds to go through an EBT in the first place.

EFRBS Rules

There are provisions in s.554P – s.554R which ensure the EFRBS legislation (ITEPA 2003 s.394) is appropriately amended to ensure that a charge can arise under the new legislation as well as under the EFRBS legislation although there is relief from any double charge.

PAYE

The PAYE legislation is also amended to ensure that a UK company can remain liable under PAYE with regards to a relevant step unless the trustees apply the PAYE code (paragraph 25 of Schedule 1 of the consultation draft).

COMMENCEMENT AND TRANSITIONAL PROVISIONS

The commencement and transitional provisions are generous and are contained in paragraphs 47 – 52 of Schedule 1 of the consultation draft.

The general rule is the new provisions have effect in relation to relevant steps taking place on or after 6th April 2011.

There are two exceptions to this.

If on or after 9th December 2010, but before 6th April 2011, the EBT, for example, pays a sum of money to the employee within s.554C(1)(a) then a charge under the new legislation arises. That charge, however, is reduced or eliminated by any amount repaid to P by the employee before 6th April 2012 (paragraph 48(4) Schedule 1).

There is a similar relief if the loan has been made by another party (say a bank) to the employee between 9 December 2010 and 5 April 2011 and the EBT has provided security for the loan; if that structure is unravelled before 6th April 2012 then even though the new loan was taken out on or after 9th December 2010 and before 6th April 2011 the charge is cancelled out.

They are the only two relevant provisions which displace the fundamental rule which is that this legislation only applies to relevant steps taking place on or after 6th April 2011.

UK Limited, for example, may have set up an EBT and the funds are earmarked for A after the 8th December 2010 and before 6th April 2011. That will not be a relevant step.

Loans made by EBTS before 9th December 2010 are in a safe position: the loans will be taxed under the old code and will not comprise a relevant step within s.554C(1)(a).

If later a pre-9th December 2010 loan reaches its repayment date and it is continued there would still be no charge because there will not have been any payment of a sum of money to a relevant person (employee) on or after the 6th April 2011 (s.554C(1)(a)). The monies would have been paid over when the original loan was made. They are not paid over again. Section 554(1)(e) states that references to a payment of a sum of money include (in particular) references to the payment of a sum of money by way of a loan. There still has to be a payment of a sum of money. Even if the alteration in the arrangement results in a new loan there would have been a re-financing without a payment of a sum of money. HMRC in *MacNiven v Westmoreland* 73 TC 1 acknowledged that one may be able to re-finance without new payments being made. Lord Hoffmann at 75E stated:-

> "Mr McCall (*Counsel for HMRC*) does not contend that payment must involve a negative cash flow which is not compensated by a cash flow in the opposite direction. He accepts, for example, that many commercial refinancing operations discharge old debts and create new ones without any cash flow either way."

Of course, a loan by an EBT to an employee made on or after 9th December 2010 and before 6th April 2011 must be repaid, if this legislation is to be avoided, before 6th April 2012.

PLANNING

No loans after 5th April 2011

If a cash loan is made by an EBT on or after 6th April 2011, then this legislation will have its fullest impact: the employee will be charged to tax as if he had received employment income of the full amount of the money lent.

For these purposes a loan would include monies raised on the issue or a deeply discounted security.

Leases can be attractive

If an asset is made over to an employee then one has to value the asset and careful planning must be carried out with regards to lease grants; the taxpayer should ensure the situation comes within s.554C(1)(b) or (e) or under the general employment income legislation. One must avoid coming within the third head (making assets available). The taxpayer should not simply be allowed to use land or premises: a formal lease should be granted.

Third party payments are problematic

If payments are made to third parties not connected with A, and not being persons chosen by A and there are no directions or requests made by A and the payment is not made on behalf of A the provisions of s.554C(2)(a) may be avoided. One must, nevertheless, see whether s.554C(1)(b) applies (i.e. whether an asset results from the payment and that asset accrues for the benefit of the employee (A) or persons connected with him).

QROPS and QNUPS – their fate is awaited

The position with regards to QROPS and QNUPS must await the outcome of the statutory instruments but they are potentially caught by the draft legislation as it stands. Some thought may be given to seeing whether EFRBS can be converted into QROPS and whether QROPS can be registered with HMRC as registered pension schemes.

Tax Free Roll-up funds – choose your tax point and tax relief

If funds (post-5th April 2011) going into an offshore EFRBS and are not earmarked for any particular employee then the first relevant step (earmark) is not satisfied and no charge arises at that point. This means that the monies can be rolled up generally free of income and capital gains tax and without any adverse inheritance tax consequences. At a later date, funds may be made available to former employees at a time of the taxpayer's choosing – tax charges may arise at that later date and one must ensure that one claims the appropriate corporation tax relief at that time; in the interim, while the fund is grossing up, one can ensure that accommodation is made available to employees without the new legislation having an adverse application but one must note the charge is based on the higher of market value and cost (see s.554K(2)).

Assets of low value

Although new loans are prohibited under the new legislation, it may be that assets which have potentially super future growth (shares in certain banks have been mentioned to the writer) could be made over to employees at a time when their value is low.

Reducing value

One is also likely to see schemes emerging to manipulate values but in that context one must note the *PA Holdings* case in the Upper Tribunal referred to above which has given a "breathtaking" extension to the meaning of income arising "from" an employment.

Extant loans

Pre 9th December 2010 loans to employees can be left outstanding.

Extant asset user

If assets are made available to employees to use before 6th April 2011 the new provisions do not apply.

School fees paid direct to the school should be paid upfront (for many years) before 6 April 2011.

Ex-employees

There is some scope for an EBT to acquire an asset and transfer it to an ex-employee's family before 6th April 2011 without an employment charge or a NIC charge.

Gold Schemes

There is scope for an EBT to acquire numbered gold bullion, say, and sell it to an employee, with the purchase price being left outstanding before, 6th 2011 and this new charge (as there will be no payments of money). One must expect a hostile reaction from HMRC – see Spotlight 11 (3 March 2011).

Self-Employed

These provisions are wholly irrelevant to self-employed persons and trusts for self-employed persons: the tax planning for the future will move in that direction.

OVERALL

In general, the writer would anticipate that EBTS, EFURBs, QROPS and QNUPS in one guise or another will continue to be set up and used by taxpayers.