THE DISGUISED REMUNERATION RULES AND PART 7A ITEPA 2003[1]

by Patrick Way

This articles explores and considers the new disguised remuneration rules in the context of their history and likely effect for the future

The expression employee benefit trust (EBT) has come to mean a general form of trust created for employees, but without the ability to pay what may loosely be called retirement benefits. An employer-funded retirement benefits scheme (EFRBS) is, strictly speaking, a particular form of EBT which includes a power to pay "relevant benefits" as defined at Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) s.393B: broadly – "retirement benefits". This article, however, treats EBTs as pure employee incentive trusts and EFRBS as retirement orientated trusts for employees.

How did we get here?

EBTs became popular in the late 1970s, before a company could buy back shares as a matter of law, as a holding entity for the company's cash. A company could fund an EBT periodically, and the cash in the EBT could be utilised to acquire shares from a retiring proprietor. The trustees might then use dividend income from the shares to reward beneficiaries of the EBT, or else the trustees might simply transfer some of the shares to such employees outright. So, the rationale of the trust extended from being a cash box to an incentive arrangement.

Pausing here, until *Dextra Accessories Ltd & Others v. MacDonald*[2] changed all this, the tax position was straightforward. The capital costs of funding the EBT were not deductible in the hands of the company, taking account of the ratios of the cases of *Atherton v. British & Helsby Cables Ltd*[3] and *Heather v. PE Consulting Group Ltd*[4], but the revenue contributions were. The trustees of the EBT were independent from the company, taking account of trust law and the fact that the EBT's rules governing the trustees' acts were set out in the trust document. This position could be contrasted with a share option scheme, where the company and the trustees did act in tandem with the trustees typically holding shares and waiting for instructions from the company in respect thereof.

Continuing the tax analysis, the beneficiaries of the EBT remained discretionary beneficiaries, and until such time as they received anything from the trust there would be no tax to pay. Until the time of *Dextra* there was no suggestion that trustees were intermediaries: Finance Act 1989 (FA 1989) s.43 was universally ignored, by advisers and the Revenue, in the writer's experience. Employees were taxed only as and when they received cash or assets from the EBT, taking account of the ratio of *Brumby v. Milner*.[5] So, there was tax asymmetry: a full tax deduction but no taxable receipts.

The final straw for what is now HMRC was the widespread use of loans from the trustees to beneficiaries. These might be at a rate of interest which was the same as the official rate, in which case no tax would arise (ITEPA 2003, s.175). Alternatively, there might simply be no interest, in which case tax on the amount of interest foregone would arise. Given that interest rates dropped dramatically, lending significant amounts to an individual from an EBT interest-free and possibly for a long period of time proved to be very attractive. Eventually, something had to give, and the

case of *Dextra* was the first opportunity for HMRC to challenge matters. *Dextra* involved payments into an EBT and the fact that sums were set aside into separate sub-funds loosely being for the benefit of named beneficiaries and then lent out. So we can see there was an additional issue being the relevance of sub-funds: did they amount to a taxable benefit being received by a beneficiary?

One of the oddnesses about *Dextra* was that the taxpayer won both before the Special Commissioners and the High Court (on the basis that there was full deductibility for the contributions), with the consequence that new legislation was introduced in the interim before the Court of Appeal hearing to ensure that payments into an EBT would not be deductible except as specified. This additional legislation, however, which is now found in Corporation Tax Act 2009 (CTA 2009) ss.1288 and 1289 to 1296 was not necessary, as HMRC won in the Court of Appeal and the House of Lords on the basis that payments into the trust fund represented potential emoluments pursuant to FA 1989 s.43, and the trustees were held to be intermediaries holding those potential emoluments in the interim. Nevertheless, HMRC lost on two points. First, the creation of sub-funds did not necessarily cause any beneficial ownership of the assets to vest in the relevant individuals; and, secondly, a loan was not an emolument.

In *Sempra Metals Ltd v. HMRC*[6] the court had to consider the "new" definition of employment benefit contributions (in circumstances where the relevant documentation described a family trust rather than an employee benefit trust) and also the taxation treatment of sub-funds. The ratio in *Dextra* was upheld (no deduction in respect of the contributions, but no tax in respect of the sub-funds), but the particular circumstances of the loans were such that emoluments arose. The case was then settled before the matter could be heard on appeal.

What was required

So it is that we come to HMRC's requirements underlying the new disguised remuneration rules. Based on the foregoing, we can say that HMRC's wish list to the Parliamentary draftsman would have included the following:-

- a wide definition of an EBT or an EFRBS perhaps to take account of the sort of arguments that were rehearsed (unsuccessfully) in *Sempra* as to the meaning of the expression employee benefit trust. HMRC's wishes were certainly granted when one looks at ITEPA 2003 s.554A and the wide definition utilised;

- put a stop to the use of sub-funds. Again, HMRC were successful on this front because we now have the concept of earmarking, principally found at s.554B;

- tax any sort of a loan whatsoever and, to be on the safe side, give a very wide meaning of payments and loans. This is achieved within s.554C, which deals with payments of sums and transfers of assets including loans;

- finally, make sure that any kind of involvement of an EBT or EFRBS or similar which benefits an individual employee is taxed.

There was, however, no kind of motive test. As a result, some fully commercial transactions run the risk of being caught, and, in rather unfortunate modern style, in addition to very complicated legislation we have extremely long "exclusion clauses" in the form of answers to frequently asked questions and in the amended employment income manual. Where the legislation applies PAYE and NICs are due, and it is the obligation of the employer or former employer to operate these.

Where do the new rules apply?

The starting point is that ITEPA 2003, Part 7A, specifically s.554A (being, broadly speaking, a definition of EBTs and EFRBS but covering arrangements generally), is extraordinarily widely worded and therefore is capable, at first blush, of catching very many situations where an employer and an employee have some sort of arrangement concerning remuneration. HMRC seem to acknowledge that this is the case – and have produced lengthy informal exclusions to the rules. It should be said at the outset of our consideration of Part 7A that the disguised remuneration rules require some kind of trust arrangement and can be avoided by having a direct relationship between an employer and an employee without trusteeship.

The new rules will not apply to the grant of a share award or option, nor to the issue of shares to an employee to satisfy the vesting of an award or exercise of an option. Nor will the rules apply in respect of pension income. In other words, Part 9 of ITEPA takes precedence over Part 7A. Further, under s.554S it is provided that pension payments will be subject to tax under Part 9 in priority over Part 7A. This means that the remittance basis and the ten per cent abatement for foreign pensions will continue to apply where appropriate. To the extent that a pension scheme is not excluded under s.554E, it will, however, be liable to Part 7A charges on any new relevant step which constitutes earmarking (see later) on or after 6 April 2012, with credit given against the Part 9 charge for earlier Part 7A charges.

As mentioned, one of the practices which the legislation was to stop was the use of sub-funds, and this has been implemented through the concept of earmarking – which is an unusual word but seems to be directed at a single act of earmarking. Someone has put to the writer the question, whether once you earmark something it is continuously earmarked, and therefore there is a whole series of charges, but s.554B does not seem to operate on that basis.

There were also concerns that the new rules in relation to earmarking might apply to hedging arrangements for employee share plans, that is to say where shares are held in an EBT to satisfy awards granted by a company to its employees and directors. However, HMRC has confirmed that in general there will be no such earmarking where the EBT trustees themselves have not granted the awards to employees and do not know the identity of the employees involved. It is rather odd to have some sort of a non-statutory exemption where trustees are "kept in the dark".

Further, there are provisions dealing with the position if funds or assets are earmarked for a particular individual and then subsequently earmarked for another purpose, so that the employee never has entitlement to the earmarked funds or assets. In this situation, relief is available pursuant to s.554Z14. Relief has to be claimed by the employee within four years. Similarly, the position is covered where income which has arisen on a contribution to a trust is earmarked for a particular employee or

their families. In these circumstances, the earmarked income is not subject to an employment income charge under Part 7A, because income arising on funds or assets already earmarked for a particular employee (for example, held within a sub-trust for a particular employee) will be excluded from an earmarking charge by virtue of s.554Q.

It also seems to be the case that if sums are put into some sort of an EBT or EFRBS arrangement for a wide number of beneficiaries, but no further steps are taken, that will not amount to earmarking. Again, the writer has been asked the reasonable question as to how far this applies. It is easy to see that if £10m. is put into an EBT for a discretionary class of 100 employees no earmarking arises; but what about if there are only two employees? (It seems the latter may *not* be earmarking but the position is unclear.)

The next main area of concern, as stated, was the use of loans, and the new legislation at s.554C is draconian. Consequently, a charge arises where a loan is made on whatever terms to an employee, and that charge remains even if the loan is repaid. The rules apply to any loans that are made on or after 9 December 2010, save if any such "new" loans are repaid before 6 April 2012. There have been questions as to whether there really is no credit for repayments of loan, but the legislation is clear: repayment of a loan is irrelevant. The writer has been asked whether an existing loan can be varied without creating a new charge. This seems perfectly satisfactory: no new payment of cash arises; so there can be no new loan even though, under general rules, a variation may create a new loan (see, for example, *British and Beningtons Ltd v. North Western Cachar Tea Co Ltd*[7]). There has not been the necessary new *payment* of a sum of money which seems to be required, and the mere fact that there is a new loan as a matter of law is irrelevant absent a fresh payment of money (ITEPA 2003, ss.554C(1)(a) and s.542(7)).

Employee share schemes

As already mentioned, the absence of any motive test has caused some problems. For example, one needs to look at frequently asked question 22: in connection with employee share schemes one wants to have some sort of satisfactory answer to whether it is a fairly normal commercial arrangement where shares are allocated to named employees to meet future liabilities under an employee share scheme or share option scheme or a long-term incentive plan (LTIP): here – to make a broad observation – no charge will arise under the disguised remuneration provisions. The answer to the question as set out by HMRC turns on the fact that the policy objective was to tackle avoidance. It follows, therefore, that the legislation, as changed following the brief consultation process, provides that arrangements which have certain characteristics in connection with employee share schemes do not give rise to earmarking:-

- the payment for the shares must be subject to conditions which, if not met, will mean that there is no possibility of the employee receiving the shares or retaining any form of current or future entitlement;

- the arrangements must specify a date for the vesting of the shares, which must be at most ten years from the grant;

- the nature of the arrangements must be such that if vesting does occur on or before the vesting there is a charge; and

- the deferral or avoidance of tax must not be the main purpose of entering into the arrangements.

Further, if trustees have earmarked shares to satisfy options that have been granted by the employer, and none of the exclusions arise, the trustees will have taken a relevant step, and income tax will arise merely by the trustees holding the shares involved. However, the value of that relevant step will be reduced by the amount of any exercise price that is payable by the employee, and typically this could reduce the income tax charge to zero. Further, if an employee is granted an option with a market value exercise price, and the earmarking takes place at a time when the market value of the shares is equal thereto, then the charge under Part 7A is nothing. Where, however, shares are earmarked for a nil cost option and none of the exclusions applies, then the disguised remuneration charge will apply in full.

Conclusion

It will take time for the legislation to bed down. Equally, it seems very clear that in relation to what the legislation is really targeted at (EBTs and EFRBS rather than other employer/employee arrangements), the future for EBTs and EFRBS is pretty much curtailed. Some commentators disagree and point out the advantages of EBTs and EFRBS for long-term inheritance tax planning, since the trust assets do not form part of the estate of any individual. The legislation is extremely unsatisfactory where it crosses into share option schemes and corporate incentives in circumstances where the perceived mischiefs of EBTs and EFRBS were never considered. So, practitioners will need carefully to consider the legislation and the "exemptions" provided for in the FAQs and the employment manual.

It should be said, however, that the recent Supreme Court cases of *R (on the application of Davies and another) v. R&C Commissioners*; and *R (on the application of Gaines-Cooper) v. R&C Commissioners* (SC, [2011] 2249), where taxpayers argued unsuccessfully that they had relied on HMRC clear wording, do not set a very auspicious precedent. Accordingly, it is not wise to rely, in the writer's view, on the manual or the frequently answered questions when seeking to find an answer, particularly where otherwise significant amounts of tax would be payable, and probably the most prudent course is to obtain a specific clearance in relation to any particular points of concern.

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[2] *Dextra Accessories Ltd & Others v. MacDonald* (HL 2005, 77 TC 146) ("*Dextra*")

[3] *Atherton v. British & Helsby Cables Ltd* (HL, 10 TC 155) ("*Atherton*")

[4] *Heather v. PE Consulting Group Ltd* (CA 1972, 48 TC 293) ("*Heather*")

[5] *Brumby v. Milner* (HL 1976, 51 TC 583) ("*Brumby*")

[6] *Sempra Metals Ltd v. HMRC* (SpC, [2008] SSCD 1062 (SpC 698).

[7] *British and Beningtons Ltd v. North Western Cachar Tea Co Ltd* (HL, [1923] AC 48) ("*Cachar*").