ICAEW REPRESENTATION 113/17
TAX REPRESENTATION

EMPLOYMENT INCOME PROVIDED THROUGH THIRD PARTIES

ICAEW welcomes the opportunity to comment on the draft Finance Bill legislation: *Employment income provided through third parties* published by HM Treasury and HM Revenue & Customs on 13 September 2017.

This response of 13 October 2017 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

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EMPLOYMENT INCOME PROVIDED THROUGH THIRD PARTIES (ALSO KNOWN AS DISGUISED REMUNERATION): DRAFT FINANCE BILL 2017-18

THE MEASURE IN CONTEXT

1. The clause and Schedule augment existing legislation in sections 554A-554Z21 (Part 7A) ITEPA 2003 which is intended to counter arrangements where earnings are routed via a third party and not taxed as earnings. It is part of a suite of recent measures to tackle disguised remuneration (DR) avoidance schemes.

2. Paras 1-7 and 11-13 (Parts 1, 2 and 4) of the draft Schedule introduce in new sections 554A et seq additional circumstances under which a sum of money is taxable as employment income under Chapter 2 of Part 7A ITEPA; this is to be called a **close company gateway (CCG)**.

3. Paras 8-10 (Part 3) of the draft Schedule introduce an **information requirement** on employees who are subject to the DR loan charge legislated in sections 34-35 & Sch 11-12 Finance Bill 2017-19 (soon to be Finance (No.2) Act 2017).

4. These provisions commence in April 2018.

CLOSE COMPANY GATEWAY

Summary of the measure

5. A Close Company Gateway (CCG) is introduced as an alternative to the existing gateway to Chapter 2 of Part 7. If a taxpayer and a set of arrangements fulfil the conditions in either the existing gateway in section 554A ITEPA or the new CCG which will be in 554AA et seq, Chapter 2 is triggered which in turn determines an amount to be treated and taxed as employment income.

6. The CCG was originally removed from the Finance Bill published in March 2017 to allow further thought to be given to how collateral damage could be avoided; it was felt that the original proposals would catch a wide range of commercial transactions and other uncontroversial arrangements.

Concerns

Is the CCG the appropriate tool?

7. The purpose of the close company gateway (CCG) was set out in HMRC's consultation document of 10 August 2016 as follows:

   "…some schemes try to avoid being caught by Part 7A by claiming that the disguised remuneration received by an employee or director of a close company is not in connection with their employment. The government considers that these schemes are ineffective. In order to put beyond doubt that these schemes do not work another gateway will be added to Part 7A specifically for close companies.". [*Our underline*]

8. We consider this statement to be the root cause of the difficulties with the CCG as we do not think that the targeted avoidance activity is in fact employment income tax avoidance. Part 7A is an effective employment income anti-avoidance tool but we consider it ill-suited to being refashioned in this manner to deal with other types of avoidance. And this is why the CCG will lead to collateral damage to commercial transactions and to other benign arrangements outside of HMRC's stated target.

9. We agree that if HMRC are encountering continued egregious avoidance then action should be taken. However, we do not think that the CCG is the most effective tool to do so. The collateral damage is too high a price to pay when more efficient solutions may be available.

10. We do not think that the underlying avoidance is of employment income tax because:

    - The drafting of the CCG relegates employment to almost an incidental consideration – it is in no way material to the gateway except that the individual must have been an employee (or director) at some point in time;

    - The amounts involved are clearly far in excess of what would constitute reasonable remuneration for any employment – if the value of (or a large proportion thereof) a close company is decanted into a trust then almost de facto it cannot be said to be due to the avoidance of employment income tax;

    - If it were pure avoidance of employment income tax then HMRC would have less difficulty applying the current version of Part 7A (or put another way, it is precisely because the avoidance is not purely of employment income tax that it is difficult to show that it is and so apply the current Part 7A); and,

    - Based on our understanding of the types of arrangements HMRC has in mind, our view is that they are more about the extraction of value from close companies.

11. In order to capture what we will call "extraction of value avoidance", the CCG has been drafted so that employment income tax avoidance is no longer a requirement (as hinted at above vis-à-vis the employment requirement). This in turn generates the odd result that Part 7A could be engaged and an employment income tax charge triggered even where it can be demonstrated that there is no employment income tax avoidance.

12. While this may not sound like a bad result given that there is some underlying avoidance activity, the consequence of decoupling the CCG from the requirement that there be employment income tax avoidance is that the CCG is incredibly wide. In turn this means it has the potential to trigger all sorts of collateral damage and capture all sorts of commercial transactions and benign arrangements. This is why it was originally dropped from the March 2017 Finance Bill.

13. Since March 2017 two additional filters have been added to try and focus the CCG appropriately:
    - the materiality test has been tweaked but is ineffective for a wide class of arrangements, and
    - an avoidance motive test has been included.

14. We discuss this motive test separately below but we note here that one of HMRC's stated difficulties with the current Part 7A is that it requires fact finding in each individual case and so is resource intensive. It would therefore be more attractive for HMRC to have a bright-line principle test that can be applied across the body of avoiders. On this point we are of the view that the CCG does not improve the position at all. The new CCG will not reduce the work required from HMRC as the motive test will require fact finding in each individual case as well; it simply swaps one type of fact finding for another.

15. Thus, in making avoidance activity easier to stamp out we would suggest that the CCG fails.

16. And as we discuss in more detail below, we are also of the opinion that the collateral damage to benign arrangements remains far too high. Therefore we see no value for HMRC or taxpayers generally in pursuing the CCG. As we believe the underlying issue to be about the extraction of value, we think the better approach is to expand the scope of some of the existing extraction of value anti-avoidance rules (of which there is a suite).

17. We would add for completeness that those taking an aggressive approach to the existing Part 7A will no doubt continue to do so with the CCG. Thus the compliant majority are potentially punished while the aggressive minority are no closer to being deterred.

18. The CCG does not measure up to our *Ten Tenets for a Better Tax System* (summarized in Appendix 1), in particular Tenet 5: Properly targeted.

Territoriality and Materiality

19. Both of these issues are best illustrated with an example:
    - A is a UK resident non-dom who owns a UK resident Jersey incorporated trading company (B). He is also a director.
    - As A approaches the threshold to become deemed domiciled in the UK he settles his shares of B into a foreign "protected trust".
    - He resigns as director at the same time.
    - A leaves the UK 5 years later and does not return.
    - While UK resident, the CCG is not engaged as the trustees either do not take a relevant step or more likely B does not partake in a relevant transaction.
    - 20 years after A leaves the UK, the company lends the trust £10m to acquire a French property.
    - A is granted a licence to occupy the property.

20. If we then consider this arrangement on the date of the grant of licence (being 25 years after A settled the trust and 20 years after leaving the UK, but noting that the 25 year lag is only to illustrate the territoriality issues and that the primary issues arise even if there is no lag):

New 554AA Application of Chapter 2: close companies	Analysis
(1) Chapter 2 applies if—	
(a) an individual ("A") is a director or an employee, or a former director or a former employee, of a close company ("B"),	A was a director 25 years ago
(b) there is an arrangement ("the relevant arrangement") to which A is a party or which otherwise (wholly or partly) covers or relates to A,	Settling the trust constitutes an arrangement
(c) the main purpose, or one of the main purposes, of the arrangement so far as it covers or relates to A or B is the avoidance of— (i) income tax, (ii) national insurance contributions, (iii) corporation tax, or (iv) a charge to tax under section 455 of CTA 2010 (loans to participators),	We return to the topic of the motive test below. We believe that the motive defence should apply in this situation. However, for the reasons we discuss below, we do not feel that, with such significant sums at stake, A can feel sufficiently reassured that it will be accepted that he can benefit from the motive defence. We would add that the difficulty in obtaining HMRC acceptance that the motive defence applies with respect to the transfer of assets abroad legislation is also a cause for concern in this context. For the purposes of this analysis we proceed (without prejudice) on the basis that availing of the protected trust status is deemed income tax avoidance.
(d) it is reasonable to suppose that, in essence— (i) the relevant arrangement, or (ii) the relevant arrangement so far as it covers or relates to A, is (wholly or partly) a means of providing, or is otherwise concerned (wholly or partly) with the	The trust is settled to benefit A and his family

provision of, A-linked payments or benefits or loans,	
(e) B enters into a relevant transaction (see section 554AB),	The company lends to the trust interest free and repayable on demand (a common approach). This does not appear to be an excluded transaction. The trustee does not appear to fall within the group provisions as it is not a company within the group so it constitutes a relevant third party. This therefore appears to be a relevant transaction.
(f) at the time B enters into the relevant transaction, or at any time during the immediately preceding period of one year, A has a material interest in B (see subsection (4)),	The drafting of material interest draws on s448 CTA 2010 so the trustees ownership is always consolidated with the settlor's. He therefore has material interest at all times.
(g) it is reasonable to suppose that, in essence— (i) the relevant transaction is entered into (wholly or partly) in pursuance of the relevant arrangement, or (ii) there is some other connection (direct or indirect) between the relevant transaction and the relevant arrangement,	The loan will be considered to be in pursuance of the act of settling. Certainly there is an indirect link. This is an incredibly wide filter.
(h) a relevant step is taken by a relevant third person,	The trustee grants a license to occupy. Or simply earmarks the funds to benefit the settlor. Either way there is a relevant step.
(i) it is reasonable to suppose— (i) that the sum of money or asset which is the subject of the relevant step represents (directly or indirectly), or has arisen or derives from, the sum of money or asset which is the subject of the relevant transaction, or (ii) that the sum of money or asset which is the subject of the relevant transaction represents (directly or indirectly), or has arisen or derives from, the sum of money or asset which is the subject of the relevant step.	The property is purchased using the loan funds.

21. In this example, it appears that the arrangement comes through the gateway and Chapter 2 applies.

22. Turning to s554Z4: this appears to require us to calculate the employment income charge by reference to the last year of employment. In this case that was 25 years ago when he was UK resident and undertaking UK duties. There is therefore no relief and an employment income tax charge is triggered of c. £10m by reference to the loan. As can be seen, the definition of material interest (and s448 CTA 2010) is not a filter for settlors of trusts.

23. Equally concerning is the imposition of an employment tax charge in scenarios where there has been no avoidance of employment income tax and the use of **the employment income tax territoriality rules when the employment is almost entirely incidental to the**

imposition of the charge. It is these territoriality rules that creates the 25 year look back. Worse still is that they will generate arbitrary results based on when A decides to leave employment.

24. In the example above, we would suggest that is not equitable that there is a UK tax charge at all. The individual has been non-UK resident for 20 years at the time of the relevant step. There appears to be no underlying principle upon which the UK should be asserting a right to tax. There may be Human Rights implications as a consequence. We have not considered enforceability.

25. Turning to NIC, it is clear that Reg 22A treats the "relevant amount" of Part 7A income as earnings from employed earner's employment. However within the earnings period concerned there may be no secondary contributor because de facto there is no employment arrangement.

26. As a final point, even if it were possible to fall outside the CCG, the effect would be that the trustees would need to go through this process several times a day: everything the company does would need to be measured against the relevant transaction definition and everything the trustee does (earmarking being a very low threshold) would need to be measured against the relevant step definition. So even if the CCG could be shown not to apply, the administrative burden would be intolerable.

The motive test

27. As shown above, the changes to the materiality condition is ineffective for non-dom settling foreign resident trusts. The only relevant change then since March 2017 is the avoidance motive test. In our view the motive test is not a panacea for the following reasons.

28. Is a non-dom settling a trust just before they become deemed domiciled in the UK in order to benefit from the trust protections tax avoidance? Under *Willoughby* it would appear to be a choice afforded by Parliament and so not tax avoidance.

29. While we sympathise that a motive test appears to be a neat solution in theory, it is not clear from our day-to-day dealings that "avoidance" is consistently interpreted by HMRC. Therefore it does pose practical issues and uncertainty (more on this below).

30. Nor is it clear whether now, 40 years later, the Courts would endorse such a clear statement of avoidance as found in *Willoughby*.

31. Equally importantly, it is not clear where the concept of avoidance will end up in the future. A trust could last indefinitely and the test is whether there is an avoidance motive presumably at the time of set-up. But importantly, the question will be posed in the future at a time when avoidance may not mean what it is held to mean now.

32. The CCG with its motive test will therefore constitute a considerable risk for a non-dom seeking to settle all their wealth into a foreign resident trust to avail of the Government's protected trust regime. This is because they will do so knowing that a change in the interpretation of avoidance at any stage in their life could theoretically bring them through the CCG and expose them to a UK employment income tax charge, even if they leave or have left the UK forever.

33. For this reason we think that the CCG appears to undermine the Government's concurrent efforts to introduce a protected trusts regime for a wide class of non-doms (being the more entrepreneurial non-doms which the Government has made clear it wishes to remain in the UK).

34. The immediate response may be to try and address the issue with guidance. For the avoidance of doubt, we do not see this is a workable solution. The Court of Appeal has told us

twice this year (*Revenue And Customs v Hutchinson* [2017] EWCA Civ 1075 (26 July 2017) and *Samarkand Film Partnership No. 3 & Ors v Revenue And Customs* [2017] EWCA Civ 77 (24 February 2017) that HMRC guidance is not to be relied on, so whatever finessing HMRC may seek to do in the guidance will not help with the underlying issue.

35. Furthermore, HMRC has been known to:
    - change its guidance retrospectively (not least on what constitutes tax avoidance), and
    - dispute the relevance and interpretation of its own guidance (*The Commissioners for Her Majesty's Revenue and Customs and KE Entertainments Limited* UT/2016/0203).

36. Therefore we do not believe that guidance will not offer any peace of mind to non-domiciled settlors in respect of the potentially life transforming risk that the CCG poses to them.

37. As a further point on the motive test, while it applies to the arrangements as a whole, what is not clear is the extent to which a single transaction undertaken by a trustee could taint the arrangements as a whole.

38. Put another way, even if the act of settling is seen as not constituting tax avoidance (and this is our belief), would a future action by the trustee (say on the sale of the company) structured in such a way that it does constitute tax avoidance, taint the whole of the arrangements? Such a risk that a third party action could materially impact the settlor's tax position in the manner proposed by the CCG would also be unpalatable.

39. Our final point on the motive test is in relation to s554AC(3). Coupled with the gateway conditions it is not clear that any transaction can be an excluded transaction. We assume this is an oversight.

Anti-Avoidance v Anti-Abuse

40. This final point links back to our first in that the CCG seems to be primarily concerned with "extraction of value avoidance" and appears to be operating (as drafted) as a general anti-avoidance rule for close companies. Such a rule (an anti-avoidance rule) was considered back when the GAAR was introduced and Parliament deliberately declined to pursue such a rule in favour of the GAAR.

41. We would welcome clarification of why such a rule is being proposed now in the light of that past debate and without any recent debate.

Recommendation

42. We do not think the CCG is the appropriate tool to tackle the avoidance that HMRC has identified. We therefore recommend that the CCG is not pursued.

43. However, we do agree that HMRC should act to counter the avoidance activity they have targeted and we would welcome the opportunity to help HMRC identify ways to use or repurpose or remould the current suite of anti-avoidance legislation designed to tackle extraction of value from close companies (namely the Transactions in Securities rules).

INFORMATION REQUIREMENT

Summary of measure

44. Employees (or ex-employees) within the scope of the loan charge (or, if applicable, their personal representatives) will be required to provide, between 6 April 2019 and 30 September 2019, specified information to HMRC about the loans that they received.

Concerns

45. This legislation sets out detailed requirements on users of DR loan schemes to supply information to HMRC under pain of penalties in cases of non-compliance.

46. Some employees who were users of DR schemes may not have all the required information. In many cases employees will be part of a chain and will need to obtain information from others in the chain, for example their employer and/or employee benefit trust/DR loan trust trustees. They may be unable to obtain it from others in the chain because, for example, the employer or the trust may not be still extant, or the records may have been lost, or the employer or trustees may be offshore and therefore not able to be compelled to comply. Even if on-shore, trustees may take the view that they cannot provide information because they could be construed as having breached trust.

47. The inability of employee to obtain the necessary information could result in their being liable to penalties despite having done their best to comply.

Recommendation

48. In order to put beyond doubt whether trustees of loan trusts are in breach of trust if they provide information to employers and employees, we suggest that the legislation provides that all parties to DR loan arrangements, including, for the avoidance of doubt, trustees, are obliged to provide all the data required under this legislation within a set time limit.

49. In order to protect employees who are unable to obtain information for just cause, for example, where their employer or trustees are offshore or defunct, we should welcome a statement confirming that, when levying penalties, HMRC will adopt a sympathetic view towards employees who have used their best endeavours to obtain the information.

APPENDIX 1

ICAEW 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 (see http://www.icaew.com/-/media/corporate/files/technical/tax/tax-news/taxguides/taxguide-0499.ashx).