Removing the disguise

HMRC have successfully combatted disguised remuneration and the use of employee benefit trusts. *Sean Eastwood* advises that those affected must now take steps to put their affairs in order.

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TEN SECOND SUMMARY

1. **Employment benefit trusts (EBTs) were used to provide employees with rewards or benefits with a minimal liability to tax and National Insurance contributions.**
2. **The disguised remuneration legislation treats assets earmarked for an employee as taxable employment income.**
3. **The new loan charge rules will mean that loans advanced by an EBT that are still outstanding on 6 April 2019 will be subject to PAYE liabilities.**

The *Rangers* case (*RFC 2012 plc v Advocate General for Scotland* [2017] STC 1556) has brought the issue of employee benefit trusts (EBTs) into sharp relief over the past few years. It may come as a surprise that these arrangements have been around since the early 20th century, although their use as a tax-avoidance vehicle only really took off in the late 1990s. Many cases have been through the courts in that time and legislation has been introduced by various governments, which were anxious to prevent the loss of tax and National Insurance revenues.

The background

Employers have long used trust structures as a means to segregate funds that would be used to provide employees with rewards or benefits after a certain length of service or to put aside shares as part of an employee share scheme.

In the 1990s, an increasingly common structure using EBTs was adopted. In brief, these operated as follows.

- A discretionary trust was set up (often offshore) for the benefit of all of an organisation's employees.
- Part of an employee's entitlement to remuneration would be waived.
- The employer would make payments into the EBT, with the trustees of the EBT being instructed to use the funds to provide benefits to the employee and/or their family.
- The trustees would allocate the funds to a sub-trust for that specific employee and their family.

This structure and minor variations on it were thought to give a number of tax advantages.

- The payments to the EBT were considered to be part of the company's remuneration expense. This allowed the company to obtain corporation tax relief for its contributions.
- Because the contributions could not be attributed to any one person, income tax and National Insurance contributions did not arise on them.
- Any growth in the value of assets held in offshore EBTs was outside the scope of UK capital gains tax.
- The value of assets held by EBTs were not included in the value of the employees' estates for inheritance tax purposes.

Many organisations with highly paid employees, such as banks and football clubs,

started to use EBTs. They not only offered a competitive advantage in terms of attracting and retaining key employees, but the potential employer National Insurance savings were also substantial. EBT structures became popular among owner-managers of companies who would establish such an arrangement or an employer financed retirement benefit scheme (EFRBS) to remunerate themselves.

It was inevitable that HMRC would look much closer at such arrangements, leading to the plethora of case law and legislative changes seen in recent years.

The initial legal challenges against EBTs went in favour of the taxpayer, which led the government to introduce legislation in FA 2003 restricting the tax deductibility of contributions made after 27 November 2002. Under the 2003 legislation, deductions were deferred until PAYE was operated on those payments. Not long after this legislation was enacted, HMRC found success in the House of Lords in *Dextra Accessories Ltd & Others v MacDonald* [2005] STC 1111. In that case, the court ruled that the employee had to have received a taxable benefit before a corporation tax deduction could be allowed.

Further tightening of the rules followed, with HMRC adding EBTs to their list of "Spotlights on Tax Avoidance" (tinyurl.com/y8l8ug8k) before introducing the legislation in FA 2011, inserting Part 7A into ITEPA 2003.

The essence of the disguised remuneration legislation is to treat any assets earmarked by a third party for an employee as if there was a cash payment to the employee and therefore as taxable employment income. This "payment" is subject to PAYE and National Insurance contributions.

The *Rangers* case

In April 2011, the owner of Rangers Football Club, Murray Group Management Ltd, established a remuneration trust (a form of EBT). Numerous sub-trusts were created for the benefit of the company's management team, their families, and football players at the club.

Members of the management team had the option to waive bonus payments by replacing them with contributions into the remuneration trust. These contributions were invariably routed to the employee by way of an interest-free loan.

For the players, the arrangement was not dissimilar, but their standard remuneration package had to be lodged with the Scottish Football Association (SFA). The contributions to the EBT were not included in the disclosure to the SFA; instead, the players received side letters confirming that such payments would be made on their behalf.

HMRC began litigation on the nature of the payments, arguing that they were taxable as employment income and should have been subject to PAYE and National Insurance liabilities. Rangers' defence was initially successful, with favourable outcomes in both the First-tier and Upper tribunals, until the case reached the Court of Session (CoS).

The CoS found for HMRC on the basis that contributions to the remuneration trust constituted nothing more than earnings that the employees had redirected to the trustees. As such they should be taxed on the employee in the same way that salary redirected to a spouse would be. This decision was upheld by the Supreme Court, establishing a principle that earnings of an individual paid to a third party (such as an EBT) will always be treated as taxable employment income in the hands of that individual.

The ruling has subsequently formed the basis for HMRC to begin issuing follower notices under the FA 2014 provisions to companies that had established this type of arrangement and where there were open enquiries into the years for which they had made EBT contributions. The effect of the follower notices is to order the recipients to correct their tax submissions and to pay the tax claimed by HMRC.

The loan charge

Companies that made EBT contributions are at risk of new PAYE and National Insurance charges even where the contributions were made in years that are no longer open to enquiry and are not within the scope of follower notices. This is the "loan charge" legislation, which was enacted in FA 2018.

The loan charge has been introduced to combat arrangements such as used by Rangers, when EBT contributions would be paid out to employees in the form of a loan. The employee would pay income tax on the difference, if any, between the interest that would have been charged at the official rate and the actual interest charged and, in some cases, corporation tax deductions would be claimed for the original contributions too. The amount of tax suffered by the employee was substantially lower than would have been due if the value of the loan had been paid out as a salary.

Under the new loan charge rules, any loans advanced by an EBT to an employee on or after 6 April 1999 and that are still outstanding on 6 April 2019 will now be subject to PAYE as if the employee had received taxable employment income on 5 April 2019. This will mean that the employer will need to operate PAYE and levy National Insurance on that date. The value of the loans will also need to be reported in the employee's self-assessment return.

Conclusion

Its success in the *Rangers* case and the introduction of the loan charge have given HMRC a tool-kit of options to collect income tax and National Insurance on EBT contributions, leaving employers and employees with no real means to mitigate their liabilities. Taxpayers who are affected are encouraged to seek advice as soon as possible, if they have not already, to bring their tax affairs up to date.