Loan Rangers – Who'd be a ref?

Employment Tax | Tax voice

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David Heaton blows the whistle at the end of the match

he Supreme Court finally settled the *Rangers EBT* case (*RFC (2012) Ltd in liquidation [2016]* UKSC 73) in mid-2017, but certainty appears to have been provided only to HMRC in its mission to close the tax gap. In contrast, many outsiders are still asking questions:

- How can the judgment have been correct?
- How can it be squared with the various acts of Parliament targeting avoidance that, the judgment implies, were unnecessary and misconceived? Did

Parliament not know its own mind?
- Why has the government decided to overrule the decision in legislating for the April 2019 loan charge on disguised remuneration?
- How has HMRC managed to disregard the longstanding PAYE rules in pursuing contractors?

The background

The ‘match’ came about because the old Glasgow Rangers FC (unrelated to the current club, other than in kit colour and tradition), its holding company (Murray Group Holdings) and some associated companies, in 2001 and several later years, paid players and some senior executives partly in the traditional way (ie, cash through payroll) and partly in the then-trendy way (ie, cash bonuses or even signing-on fees through an EBT structure that lent money rather than paying earnings – or so they thought …).

The structure was aimed at avoiding a tax charge on, in total, around £56m of cash that was obviously intended to reward the employees for their work. The employers in the group paid sums to a principal EBT, an offshore discretionary trust, with ‘suggestions’ as to how the money might be allocated for the benefit of certain employees. The trustees invariably followed the suggestions, which involved setting up and settling sums on 108 sub-trusts, each for the benefit of particular employees and their families, so that the trustees of the sub-trusts could lend the money to the employees. The loans were unlikely ever to become repayable, so the employees would be taxed on the basis that they had a beneficial loan rather than a payment of earnings. With the official rate of interest at 6.25% in 2001-02, the 40% tax charge on the bonuses was expected to have an effective rate of just 2.5%, albeit annually until the employees moved overseas or died.

The litigation was, as they say, a game of two halves. The taxpayer companies won 2-1 at the FTT and the decision was upheld by the UT. The tribunals accepted that the tax code dealt specifically and in detail with loans connected to employment, and that genuine loans had been made and duly documented. The employees had not received an unconditional payment of earnings. However, the HMRC coach changed tactics at half-time, and the match took on a different complexion when it resumed.

The winning argument

Having changed its corporate mind about how a tax charge should arise, HMRC introduced a new argument and won its appeal to the Inner House of the Court of Session and defeated the employer's appeal at the Supreme Court. It is very tempting, in the current climate where even legitimate structures that reduce tax liabilities are deprecated, to assume that the judges decided that what had happened was an abuse of the tax system and they would have to find a way to justify putting a stop to it, but in the process they found that a number of past anti-avoidance cases had been wrongly decided, which must have come as a surprise to many, including HMRC.

HMRC's new approach was to attack a different transaction in the chain: it argued specifically that the money was earnings when paid by the employer to the principal trust. It originated in the employee's efforts as an employee, so it must be earnings.

The employees obviously had no contractual right to a payment, and no unconditional right to draw money at that point, but any payment was a reward for services and should be taxed as such at that point. It was argued that the employees had agreed, or at least acquiesced to, the redirection of their earnings via the two trusts. The courts accepted this argument: PAYE should have been operated at that point.

RFC argued that this redirection notion could only apply where the employee had an existing legal right to draw the money personally but asked for it to be paid elsewhere, which was not the case in the carefully structured arrangements here. There was no right to draw until the principal trustees, of a discretionary trust, had appointed funds out on sub-trusts, and the trustees of those trusts had offered to make loans.

Lord Hodge dealt with this by noting that there is nothing in ITEPA 2003, s62 (ICTA 1988, s131 when most of the original transactions occurred) that forces remuneration to be received by the employee before it is classed as earnings. The employees were entitled only to have payments made to the principal EBT, but that did not change the source or nature of the payments as earnings from the employee's efforts.

Lord Hodge did accept that 'perks' were specifically required to be 'obtained by the employee' in money or money's worth if they were to fall within the s62 definition (see s62(2)(b)), but the funds here did not become beneficial loans until late in the series of transactions, well after the money had been paid as taxable earnings to the principal EBT. The employer should have operated PAYE at the first point of payment.

Unintended consequences?

But is this really the right answer? Let’s take a closer look.

Accepting that the payments to the principal trustees were indeed taxable earnings constituting PAYE employment income within what is now ITEPA 2003, s683, we then have to apply the PAYE regulations as mandated by s684. Reg 21 of the PAYE Regulations 2003 (SI 2003/2682) explicitly requires deduction or repayment of tax in accordance with those regulations ‘On making a relevant payment to an *employee* during a tax year’. [emphasis added]

This has been so ever since PAYE was invented. HMRC has always accepted that employers settling an employee’s personal pecuniary liability to a third party by way of a contractual employee benefit (eg, a home telephone bill paid directly to BT, a company credit card used to fill up an employee’s car) had a P11D reporting obligation rather than a PAYE obligation. The PAYE regulations were written as they were because you cannot deduct 20% or 40% from the payment to the third party. What is this if not a redirection earnings? And we are not looking at a redirection of net pay: paying the employee’s bills is a perk of the employment, a redirection of gross earnings taxable via the P11D and a coding adjustment or SA return. The Supreme Court seems to have ruled that this approach has been incorrect since 1945. Or to have disregarded the PAYE regulations completely.

Note the stark contrast with the Contributions Regs 2001 (SI 2001/1004) which explicitly apply Class 1 NIC liability to earnings paid ‘*to or for the benefit of*’ [emphasis added] an employed earner (Reg 6). The regulations have always encompassed the settlement of the personal pecuniary liability, and Class 1A was invented to deal with practical difficulties in collecting NIC on employer-provided or -financed fuel.

How many past judges have been wrong?

‘Emoluments’ (relevant in the years 2001-2003) have always been a reward for acting as or being an employee, but they have also always been something that goes into the employee’s pocket rather than something that saves that pocket (*Tennant v Smith* 3 TC 158). While the payment by the sub-trust dressed up as a loan could easily meet that definition, it must be questionable how money going into an EBT is going into the employee’s pocket until it is at least allocated to the sub-trust.

What about the effect of contingencies? *Edwards v Roberts* (1934) 19 TC 618 and *Forde v McHugh Ltd v HMRC* [2014] UKSC 14 decided that taxable earnings are not paid as remuneration until the specified contingency occurs. Until funds are at least allocated to a specific employee’s sub-trust, it used to be open to question whether there could be a taxable payment, redirected or not.

It seems it is not necessary after all for remuneration to be unreservedly placed at the disposal of the employee for it to be taxable income, so *Sempra Metals Ltd v HMRC* [2008] STC (SCD) 1062 and *Dextra Accessories Ltd v MacDonald* 77 TC 146 were apparently wrongly decided

How much legislation has been unnecessary?

The reference to *Dextra* prompts a question about FA 1989, s43 (nowadays in CTA 2009 ss 1290-1296). This was the original legislation used by Parliament to counter the attempts by employers to advance a corporation or income tax deduction in respect of bonuses or benefits that would not be taxed, if at all, until a later period, by donating funds to an EBT that would provide loans or other benefits in kind. Unless qualifying benefits or expenses are paid by the EBT within nine months of the period-end, the employer’s tax deduction is deferred into the later period when they are so paid.

It now seems that Parliament needn’t have bothered, because the money paid to the EBT in order to fund long-term or even non-repayable loans to employees was earnings all along. If they were not bound by the four-year time limit, employers could now claim recompense for any delay in receiving the benefit of the corporate tax deduction that was deferred by HMRC under s43: money paid into the EBT before the expiry of nine months from the period-end should have been treated as earnings paid.

And now, decades later, we also have Part 7A of ITEPA, which treats loans made via third parties as earnings when they are advanced. But we now know that they are generally not loans at all but payments of earnings that should have attracted a PAYE liability when the money was paid to the third party to fund the planned loans. Part 7A is therefore irrelevant to many of the arrangements it was designed to attack.

Some scheme users are also facing a new April 2019 charge on loans that remain outstanding. Lord Hodge’s analysis would, of course, mean that there would be nothing to tax in most cases: the employees should have been taxed under PAYE many years ago and will have been borrowing their own money. Accepting this analysis would not raise any extra cash toward closing the tax gap, though, so the April 2019 charge provisions specifically override the analysis emerging from the *RFC* case (and will bankrupt many contractors who have been long-term users of what they thought were EBT loan arrangements, but that is another matter).

Contractor loans

Having raised the matter of contractor loan arrangements, it is perhaps worth a minor digression into the PAYE provisions, to question HMRC’s approach and question why April 2019 is happening, in light of the recharacterization of the many ‘loans’. Clearly, the worker should have paid (and should still pay) tax on all of their earnings, but we now know that the loans they drew down were not loans but earnings.

Most of the bulk scheme providers were offshore, employing the workers on minimum wage, paying large sums into an offshore EBT, and ‘lending’ the remainder of the ‘net pay’ to the workers month-by-month. Their services were sold to UK end-users, many of whom were in the public sector.

ITEPA 2003, s689 lays out rules for collecting PAYE on the earnings of employees of non-UK employers (outside the PAYE jurisdiction) whose services are provided to a relevant onshore person. The PAYE obligation falls on the relevant onshore person if the offshore employer fails to account for it. HMRC should therefore, in theory, be pursuing all the UK clients for the arrears that are now known to have been due. But, of course, until it discovered new tactics at half-time in the RFC case, HMRC did not know that this is what it should have been doing, and it is now out of time to issue Reg 80 determinations for all the relevant years.

Conclusion

The view that all the disguised remuneration ‘lent’ to workers over many years should have been taxed as employment income is unquestionably correct. The consequences of HMRC’s winning the argument are, however, somewhat unfortunate, if not to say worrying.

The Supreme Court appears to have overlooked the plain words and time-honoured interpretation and implementation of the PAYE legislation. It has also overturned decades of accepted interpretation on the absence of any right to be paid. In pursuit of a noble cause, perhaps, but can it be right?

Parliament has been passing anti-avoidance laws that were unnecessary – did it not know what it was doing?

HMRC should have been pursuing end-users for PAYE due from offshore intermediaries, end users who benefitted significantly from lower costs in terms of rates charged by contractors who were bidding for public sector work that is often awarded on price. Having realised its mistake, HMRC is now setting itself up to lose £millions when large numbers of contractors and former contractors file for bankruptcy when faced with tax charges for up to 20 years in a single year.

Rarely can a single case have caused so much puzzlement. Is it right that so much plain English legislation and precedent has been disregarded in order to get to a result that the court thinks is the ‘right’ answer? How are practitioners in future supposed to know what the law means, when it can be, if not completely disregarded, then at least freely reinterpreted so as to result here in a winning goal for HMRC late in extra time.