DISGUISED REMUNERATION
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MONCKTON CHAMBERS

DISGUISED REMUNERATION PART 7A ITEPA

TARLOCHAN LALL
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- The Finance Act 2011 seeks to stop the abuse of employee benefit trusts (EBTs) and employer funded unapproved retirement benefits schemes (EFURBs) to avoid income tax and national insurance contributions and effectively circumvent limitations which apply to tax approved pension schemes.
- The proposed rules are cast widely to catch innocent transactions and arrangements, but they also provide numerous gateways into safe harbours.
- Most activity in the ordinary course should not be stifled by the new rules.
- Generally remuneration provided by an employer (or group companies, in the case of a corporate group) would not be caught. The test for a corporate group was changed to 51% ownership from 75% ownership.
- However, a number of arrangements without a tax avoidance motive will suffer inequity under the new rules in their current form.
- Conventional off shore EBTs used for share incentives should survive under the new rules. Overfunded EBTs need to take care.
- The complexity of the rules is an unwelcome addition to the tax code at this point in the economic cycle because businesses will need to check that they are not inadvertently caught.
- Arrangements caught will be subject to tax and NICs under PAYE at the earliest point in time. The price for getting the rules wrong can be high.
- Steps taken in connection with existing EBTs and EFURBs may be caught, so businesses need to check. There are exclusions for accrued rights and commitments, albeit, circumscribed by conditions.
- The absence of provisions to reverse or reduce the tax charge where, for example a loan caught under Part 7A is repaid or deferred consideration is paid for the acquisition of shares gives rise to the question whether the legislation is proportionate, relative to its aims.

DISGUISED REMUNERATION PART 7A ITEPA

Part 7A ITEPA ("***Part 7A***") was introduced by Schedule 2 to the Finance Act 2011. The essential aim of Part 7A is to tackle "arrangements used for the purpose of disguising remuneration in order to avoid or defer income tax or national insurance contributions"[1]. The Exchequer Secretary to the Treasury, David Gauke MP, in Committee debates on Part 7A said:

> *"We do not want to dance around the issue any more. For every step, the avoidance industry makes a counter-step, but we have marked its card and taken a big step forward."*[2]

The provisions are described as being "necessarily comprehensive"[3] and complex. They strike widely used arrangements beyond the aim of the legislation and then exclude them by providing, what will be called, gateways, which are defined. The Exchequer Secretary to the Treasury, in Committee said:

> *"We have had to adopt a broad approach that captures the essence and range of avoidance activity. We have used carefully targeted carve-outs to ensure that arrangements that do not involve tax avoidance are not affected."*[4]

Part 7A is aimed at arrangements 'using trusts and other vehicles' including EFURBS[5]. On the whole, the legislation is aimed at arrangements which were regarded as being unacceptable. Most of the widely used arrangements, such as share incentives linked to employee benefits' trusts (EBTs) find their way into the safe harbours. The greatest risk is that the complexity of the legislation may catch arrangements which are not within the mischief at which Part 7A is aimed. That risk was reflected in representations made on the draft legislation and referred to in the debates on the Finance (No.3) Bill in Committee. There is also much concern that HMRC will not have the resources to deal with the new rules. The complexity of Part 7A is an unwelcome addition to the tax code, because it will add to compliance costs for businesses. It is necessary to examine the details of the legislation to assess whether it applies in any given situation. HRMCs' publication of responses to sixty Frequently Asked Questions in itself illustrates that the need for careful examination of the new rules.

[1] HMRC - 'Finance (No. 3) Bill: Disguised Remuneration Legislation - Frequently Asked Questions' version 3 5 July 2011.
[2] Hansard 19 May 2011, Public Bill Committee Debates, Col 290.
[3] HMRC – 'Finance (No.3) Bill: Disguised Remuneration Legislation – Frequently Asked Question' version 3 5 July 2011.
[4] Hansard 19 May 2011, Public Bill Committee Debates, Col 279.
[5] Consultation paper on Disguised Remuneration issued on 9 December 2010.

However, it is considered that Part 7A should not stifle economic activity in its ordinary course, although there are understandable concerns amongst businesses to the contrary. Part 7A applies to "relevant steps" taken on or after 6 April 2011. Tax is due under PAYE, with transitional provisions for relevant steps taken before the Finance (No.3) Bill 2011 became the Finance Act 2011.

Draft legislation was first published in December 2010. It was re-written very substantially in March 2011. Circa ninety seven (97) amendments were introduced at the Committee stage of the Finance (No.3) Bill 2011. This note is based on the Finance Act 2011, which received Royal Assent on 19 July 2011. The principal objective of this note is to outline the features of the new code for disguised remuneration with some analysis. Inevitably, owing to the relative complexity of the vehicles and arrangements within the aim of the new code, the actual impact of the rules can only be assessed by testing them against any given set of circumstances.

STRUCTURE

Schedule 2 to the Finance Act 2011 consists of 64 paragraphs. Paragraph 1 creates Part 7A. The Finance (No. 3) Bill 2011 version of Part 7A comprised 41 sections. Those 41 sections were labelled section 554 ITEPA suffixed by letters of the alphabet and a combination of letters of the alphabet and numerals. Part 7A, as enacted, contains 47 sections. The Parliamentary Draftsman exhausts the whole of the alphabet before reaching the charging provision at section 554Z2.

Paragraph 1 of Schedule 2 (i.e. Part 7A ITEPA) is divided into three chapters.

Chapter 1

- Sections 554A to 554D set out the scope of the arrangements to which the provisions apply.
- Sections 554E to 554X contain exclusions, which will be referred to as gateways to safe harbours. Section 554Y permits further gateways to be introduced by regulations and for Part 7A to be modified.
- Sections 554Z and 554Z1 set out some interpretation provisions.

Chapter 2

- The charging provision in section 554Z2 is followed by the provision prescribing the taxable amount (s554Z3).
- Sections 554Z3 to 554Z15 provide for, what may be described as secondary gateways. There are provisions on the computation of the taxable amount, reliefs, residence and the remittance basis and other supplementary provisions which will essentially determine whether or to what extent tax may be due.

Chapter 3 (introduced at the Committee stage)

- Sections 554Z16 to 554Z21 deal with arrangements by which undertakings are given to make contributions to essentially a retirement benefit scheme which is not a registered pension scheme, such as an EFURB.

The rest of Schedule 2 provides as follows:

- Paragraphs 2 to 51 contain consequential changes to the relevant parts of ITEPA (including the primary PAYE rules), ITTOIA 2005 (restriction of deduction in respect of employee benefit contributions for income tax purposes), ITA 2007 (remittance basis), CTA 2009 (restriction of deduction in respect of employee benefit contributions for corporation tax purposes), TCGA (adjustment to base cost);
- Paragraphs 52 to 63 deal with the commencement and transitional provisions, including anti-forestalling provisions for relevant steps taken between 9 December 2010 and 6 April 2011; and
- Paragraph 64 gives the Treasury the power to introduce, by 5 April 2015, secondary legislation to deal with interactions between Part 7A and other provisions in the Taxes Acts, and amend, repeal or revoke any relevant primary or secondary legislation, including provisions of Part 7A. An order under paragraph 63 may have retrospective effect so long as any person's tax liability is not increased.

The need for 20 sections with exclusions and further secondary gateways illustrates the wide scope of the arrangements to which Part 7A may apply. The general approach, therefore, it to catch anything which may be within the mischief the subject of this code and provide gateways for those arrangements which are not intended to be caught.

PROCESS

The scope and complexity of Schedule 2 is such that if any step is taken to reward or recognise an employee's efforts by an employer, some basic questions need to be asked. Firstly, salary and benefits provided by the employer in the normal course are generally not caught by the disguised remuneration provisions. Normal rules apply to them. In every other case the following questions should to be asked:

- Is the arrangement caught by Part 7A?
- Does it pass through a gateway to a safe harbour?
- If not, which employee's taxable income is it?
- What is the taxable amount? Does the arrangement pass through a secondary gateway, and if so, to what extent?
- Are there any other consequences?

HMRC state that they have attempted to limit the impact of the legislation "on employers and individuals *where it has been possible to identify arrangements* that are not used for avoidance purposes"[6] *(emphasis added)*. The precise details of any given facts will determine whether or not any of the provisions apply. This note is confined to the principles which can be derived from the draft rules. By way of illustration of how those principles would apply in practice, reference will be made throughout the note to a selection of incentive arrangements in current usage. The disguised remuneration rules also apply to retirement benefits and benefits provided through employee benefits trusts. Attention will also be drawn to the impact of the rules on the arrangements which are intended to be caught.

COMPONENTS OF PART 7A

(i) What is caught by Part 7A?

An arrangement, which "it is reasonable to suppose", in "essence" is wholly or partly a means of providing, or is concerned "with the provision of, rewards or recognition or loans in connection with" a current, former or prospective employee ("***A***") of an employer ("***B***") is within the scope of Part 7A. Such an arrangement is a relevant arrangement. The trigger for a tax charge is a "relevant step", which "it is reasonable to suppose that, in essence", is taken, wholly or partly, pursuant to the relevant arrangement or in connection (directly or

[6] HMRC – 'Finance (No.3) Bill: Disguised Remuneration Legislation – Frequently Asked Question' version 3 5 July 2011.

indirectly) with it. The relevant step must be taken by a "relevant third person". References to A (employee), B (employer) and P (a third person, who may be the relevant third person) used throughout the rules will also be adopted in this note.

An arrangement includes any agreement, scheme, settlement, transaction, trust or understanding, whether or not legally enforceable. It does not matter that the arrangement does not include details of steps which will or may be taken in providing the reward, recognition or loan. All relevant circumstances must be taken to into account to get to the "essence of the matter". The references to reward and loan and the valuation provisions suggest that the 'substance' of the arrangements must have some economic value. That economic value must be pinned to an employee directly or indirectly for a charge under Part 7A to stick.

References to A include any person linked with A. Persons linked with A are defined and include any person connected with A and any close company in which A is or has been a participator. Cohabitees living together as if they were spouses or civil partners are also treated as linked.

"In essence"

The phrase "in essence" is used four times in s554A. S554A (1) (c) refers to the essence of relevant arrangements. S554A (1) (e) refers to the essence of a relevant step or whether there is in essence a connection between the relevant step and the relevant arrangement in question. S554A (6) refers to the provision, in essence, of rewards or recognition or loans. Finally s554A (12) provides that all relevant circumstances must be taken into account "in order to get to the essence of the matter".

Part 7A marks the debut of the phrase "in essence" in UK tax legislation. It has not been used in any of the recent tax simplification statutes. Essences for the production of beverages are excluded from the scope of zero rating under the Value Added Tax Act 1994 (Schedule 8, Group 1). A number of non-tax statues use the word "essence". For example, whether time is of the essence under a contract is referred to in s41 Law of Property Act 1925 and the s10 of the Sale of Goods Act 1979. The essence of common law offences is referred to in s2 Obscene Publications Act 1959 and Sch 15, para 6 of the Broadcasting Act 1990.

Whether Part 7A also marks the introduction of the concept of substance over form[7] into UK tax legislation remains to be seen. The courts have in recent years developed jurisprudence on making objective assessments of events in question in giving statutes purposive construction. A clue to the adoption of the phrase "in essence" may be found in the recent Court of Appeal decision in The Commissioners for *HM Revenue and Customs v David Mayes [2011] EWCA Civ 407*. The case concerned income tax legislation on life assurance policies and a scheme designed to effectively generate tax deductions, which was not "a simple one, even for tax experts". LJ Mummery reiterated the requirement for the courts to establish, in applying the *Ramsay* principle, whether the actual transactions in question answer the statutory description in point. Part 7A appears to be creating a statutory description which would require the courts to exercise judgement in establishing the essence of the transactions. That appears to mark a shift in favour of the doctrine of substance over form.

Relevant Steps

Relevant steps fall into three categories, namely, what may be described as the:

- allocation of money or assets;
- vesting of money or assets; or
- making available of assets.

The allocation of money or assets may take the form of their being:

- earmarked ("however informally"); or
- starting to be held specifically

in each case with a view to a later relevant step being taken in relation to that sum of money or asset or any sum or asset which may derive (directly or indirectly) from the first sum of money or asset. An employer's act of earmarking or starting to hold money or assets with a view to meeting an undertaking essentially for a contribution to a vehicle for providing retirement benefits otherwise than under a registered pension scheme, may also be an allocation event. The allocation constitutes a relevant step even if the step:

[7] The statement accompanying the consultation draft legislation published on 9 December 2010 declared that "legislation will be introduced in Finance Bill 2011 to ensure that were a third party makes provision for what is ***in substance*** a reward or recognition or loan in connection with the employee's employment, an income tax charge arises" (emphasis added).

- has not been worked out;
- is conditional;
- is one which A, or any person linked with A, does not have the legal right to have taken.

'Earmarking' is not defined. It may be informal. Earmarking may not take the form of a readily identifiable event. However, it must follow that HMRC will have to point to some objective evidence to show that assets or money have been set aside or marked out for the purpose of a later relevant step.

Vesting may occur by a relevant person receiving payment of money; acquiring an asset (by transfer unless the asset is securities, an interest in securities or a securities option where the acquisition may be in any manner, eg by an issue of shares); having the use (in any manner) of assets which enables the relevant person to secure a loan or meet any liability; or being granted a lease which is likely to exceed 21 years. A relevant person is A, a person chosen by A or within a class of person chosen by A, or P (the person holding the asset) if P acts on the direction or on behalf of A.

The making of assets available is a relevant step where the asset is not transferred to the relevant person, but that person can benefit in a way which is substantially similar to the way the relevant person would have been able to benefit as transferee. The asset may be made available at any time. Where the asset is made available or continues to be made available two or more years after A ceases to be B's employee, the asset must be made available to the relevant person to benefit from it. The asset may be made available in any way, formally or informally, and whether or not a person has a legal right to benefit from the asset. The trigger for a tax charge is the making available of the asset, even if the relevant person does not actually benefit from it. Section 554D on its own appears to be unworkably broad. It is necessary to return to s554A(1) for a reminder that there must be something to link the availability of the asset in question to A. Section 554D(7) lists factor which, "(among others)" may be taken into account in determining whether a relevant step has been taken, such as any limitations on the way a relevant person may benefit from the asset, the period over which the asset is made available, the extent to which the relevant person has the power to influence the disposal of the asset or the use of its disposal proceeds. HMRC's answer to FAQ 7 seeks to reassure that something more than an asset "simply being at the employee's disposal or being available for the employee's private use" is required. The key appears to be

that the availability of the asset must be substantially similar to having the ability to benefit from the asset as if the relevant person were a transferee. A similar concept has been developed in the jurisprudence of the European Court on the meaning of leasing or letting for the purpose of the 2006 Principal VAT Directive, which forms the basis of Value Added Tax. Broadly, it is established law that leasing and letting gives rights of occupation 'as owner' and the quality of those rights distinguishes leasing and letting from a mere permission to enter land. There has been much litigation over the application of that concept to activity adopted in practice. Many cases turn on their own facts. It seems inevitable that application of s554D will lead disputes which will fall to the courts to be decided.

Two or more relevant steps need not be mutually exclusive. A relevant arrangement may involve more than one relevant step. Two or more relevant steps may overlap. This is acknowledged by a computational provision (s554Z5) which adjusts the taxable amount on the later relevant step.

The presence or absence of any tax avoidance motive does not feature in sections 554A to 554D, which define the scope of Part 7A other than in one limited respect (see the references below to corporate groups and limited liability partnerships). Broadly the absence of a tax avoidance motive is, in many cases likely to be a final hurdle that would need to be jumped in order to clear a number of the gateways.

"Relevant third person"

The relevant step must be taken by a relevant third person. That person may be A or B acting as a trustee, or any other person whether or not a trustee. Although the disguised remuneration code is aimed at stopping abuse through the use of EBTs and EFURBs, HMRC's reply to FAQ1 declares that the rules may apply to other third parties.

Generally, where an employer provides a benefit to an employee, the benefits may be taxable under another provision, but they would be outside the scope of Part 7A. References to a corporate employer which belongs to a group of companies is expanded to include all of the group companies, provided there is no connection with a tax avoidance arrangement. Therefore, shares issued by a holding company to the employees of a subsidiary would not be caught by Part 7A (unless there is a connection with a tax avoidance arrangement) because the holding company would not be treated as a relevant third person. The same would apply to loans made to employees by another group member.

The definition of group adopted for these purposes, derives from the Taxation of Chargeable Gains Act 1992. A corporate group under those provisions includes the principal parent company and its 75% subsidiaries. If a group member has a subsidiary, that subsidiary must be a 75% subsidiary. Each group member must be a 51% subsidiary of the principal company. In response to concerns that this definition of a corporate group would have been too restrictive in practice, at the Committee stage, a change was introduced whereby the TCGA test is retained but 51% is substituted for 75%. Therefore a corporate group would consist of a principal company and its 51% subsidiaries. A group member's subsidiary must be its 51% subsidiary and a 51% subsidiary of the principal company. Furthermore, the principal company must have 51% economic ownership of those subsidiaries.

Also excluded from the category of relevant third person are wholly owned subsidiaries of a limited liability partnership, again provided there is no connection with a tax avoidance arrangement. A loan made by a 90% subsidiary of B, an LLP, to the employee of B would by made by a relevant third person because that subsidiary would not be a wholly owned subsidiary of B.

There is scope for reaching the conclusion that many arrangements will not be caught by Part 7A. The structure of the provisions and pragmatism may, however, result in the adoption of a rule of thumb by many that rather than testing whether given arrangements are within the scope of Part 7A, a presumption that they are should shift attention to a search for a gateway or a secondary gateway.

(ii) Existing arrangements

Part 7A will apply to relevant steps taken on or after 6 April 2011. Post 5 April 2011 relevant steps are not protected by the commencement provision where they are taken under relevant arrangements made before 6 April 2011, or where assets or money were earmarked before 6 April 2011 with a view to later steps being taken. There are also anti forestalling provisions for relevant steps taken between and including 9 December 2010 and 5 April 2011. This means that pre 6 April 2011 arrangements are not protected in the way than might at first appear.

HMRC have made clear that the introduction of the new rules does not indicate that they accept a transaction caught by the new rules after 9 December was effective in escaping tax under the existing legislation. They intend to continue any challenges to such transactions,

where necessary by litigation[8]. HMRC issued a statement on 20 April 2011 outlining terms on which they may be prepared to settle outstanding enquiries relating to EBTs used by employers where HMRC believe income tax and national insurance contributions liabilities arose under the existing legislation. This note does not touch on Inheritance Tax issues or other tax issues which may arise in relation to EBTs. HMRC also issued a Business Brief 8/11 on 4 April 2011, which updates their views on how IHT issues affect EBTs.

HMRC have confirmed that loans "paid" and assets made available before 6 April (subject to the anti-forestalling provisions) are outside the scope of Part 7A. However, the anti-forestalling provisions would apply to a loan agreed before 9 December 2010 but paid after that date. The reallocation of a loan or assets made available before 6 April 2011 may be caught by Part 7A. HMRC also state that assets of sub-funds of EBTs created before 6 April 2011 but made available after that date will be within the scope of Part 7A.

Where assets were earmarked before 6 April 2011 but are made available or transferred after that date, their transfer or making available will constitute a relevant step within Part 7A. Paragraph 59 of Schedule 2 gives the employer and employee the option to agree with HMRC that the tax may be paid by reference to the earlier earmarking of the assets. One situation where the option may be utilised could be in the case of a sale of a company where the exposure to taxes is considered to be material.

(iii) Gateways

Relevant steps within the scope of Part 7A would not be subject to charges under chapter 2 of Part 7A if they pass through gateways outlined below.

- ***Steps taken under HMRC approved Share Incentives Plans, Save As You Earn schemes, Company Share Option Plans and certain pension schemes.*** The exclusion for HRMC approved schemes in the earlier draft rules appeared to be unduly narrow owing to the requirement for the step to be under such scheme as there are many such approved schemes which operate in conjunction with EBTs. The exclusion has been substantially re-written. Essentially shares within EBTs earmarked for the sole purpose of awards under SIPs or to be provided pursuant to SAYE or CSOP options would also pass through the gateway

[8] HMRC – 'Finance (No.3) Bill: Disguised Remuneration Legislation – Frequently Asked Question' version 3 5 July 2011 FAQ56

if specified conditions are satisfied. There must not be any connection with a tax avoidance arrangement. The EBT must not typically hold shares exceeding the maximum number reasonably expected to be required over a ten year period. In the original drafting, there was also an exclusion for 'excluded share arrangements', which have been removed, probably as they were defective in any event. There is a similar provision for Enterprise Management Incentives options.

- The following ***commercial transactions*** would be protected, provided they are not directly or indirectly connected with any tax avoidance arrangement, namely:

    - loans made on ordinary commercial terms within the meaning of s176 ITEPA (loans made by a person in the ordinary course of business which includes the lending of money or the supply of goods or services on credit); or
    - a relevant step taken by a person (P) for the sole purpose of a transaction entered into by P in the ordinary course of P's business. A substantial proportion of Ps' business must involve similar transactions with the public; and the transaction concerning A must be on terms which are substantially similar to those P normally adopts in similar transactions with the public.

HMRC's reply to FAQ 14 confirms that loans made by a company in the same group as the employer at the time the loan is made is not within the scope of Part 7A provided there is no connection with a tax avoidance arrangement.

- Certain ***loans and benefits provided under a package of benefits***, in the ordinary course of P's business, provided there is no connection with a tax avoidance arrangement. In the case of loans, a substantial proportion of P's business must involve making similar loans to members of the public; and the package of benefits must be available to a substantial proportion of B's employees. In the case of non-loan benefits, the package of benefits can be available to a substantial proportion of B's employees whose status is comparable with A's status. If B is a company, the majority of employees to whom the package is available must not have a material interest (essentially 5% of the ordinary shares capital) in the company. Loans made by the trustees of an EBT would not be expected to pass through this gateway because it is difficult to see how an EBT would satisfy these conditions.

- ***Earmarked deferred remuneration*** (money or assets) provided the remuneration vests within 5 years after the award date and there is no connection with a tax avoidance arrangement. This gateway allows tax to be deferred to the vesting date. A number of detailed conditions must be satisfied including the following. The remuneration must be taxable under PAYE if it were provided on the award date. The vesting date must be specified. The terms of the award must provide for the revocation of the reward if specified conditions are not met on or before the vesting date. At the award date, there must be a reasonable chance that the deferred remuneration will not vest.

  There was concern that s554H gave rise to a number of issues, which had not been clarified by HMRC's responses to FAQS 17-21. Good and bad leaver provisions, often being subject to the exercise of board discretion, are widely used in incentive schemes. The original draft of s554H stated that the deferred remuneration had to be provided on "(and not before)" the specified vesting date, which made it unduly restrictive. The redrafted s554H(c) now states that the main purpose of the deferred remuneration terms must be to defer the provision of the deferred remuneration to a specified date while providing that the award would be revoked if specified conditions are not met. Section 554H (e) provides that on the award date, there must be a reasonable chance that the deferred remuneration will be revoked where not all of the specified conditions are met. This change seeks, for example, to accommodate conventional good and bad leaver provisions but it does not deal with the matter directly. It is repeated in amended form in later provisions 554J and 554L. HMRC's answer to FAQ17 revised in July 2011 broadly confirms that the provisions mentioned above would cover bad leaver provisions, even if they give the board discretion to override the bad leaver provision in exceptional circumstances. That assurance is couched in strict terms. Therefore, such bad leaver provision and the related conditions would have to be carefully drafted. The exercise of discretion by the board to override bad leaver provisions must also be monitored to ensure that the override only operates in exceptional circumstances.

- ***Incentive schemes under which awards are based on the market value of shares.*** The awards may be in the form of money or shares or securities. Examples of schemes to which this gateway applies are long terms incentive plans and phantom schemes. The gateway essentially protects plans which seek to defer tax

to the vesting date. A number of detailed conditions must be satisfied including the following. There must not be a tax avoidance motive. The vesting date, not later than ten (increased from five) years after the award date, must be specified. The terms of the award must provide for the revocation of the reward if specified conditions are not met on or before the vesting date. At the award date, there must be a reasonable chance that the deferred remuneration will not vest. The issues for good and bad leaver provisions mentioned above equally apply for these incentive schemes. In both cases, if an award vests before the vesting date and there is an income tax charge on the vesting, the gateway would be protected.

- ***Share awards linked to an exit event*** such as a share or asset sale or a flotation. The provisions for this gateway were rewritten at the Committee stage as the original provisions were unduly narrow and conditional on the award being in a sum of money. Many private companies link vesting to an exit owing to the lack of liquidity in their shares. Corporation tax relief under Part 12 of Corporation Tax Act 2009 (formerly in Schedule 23 Finance Act 2003) is tied to the acquisition of shares. The re-written provisions permit awards to be for the payment of money or the award of relevant shares (which includes certain securities) upon an exit event. All or a substantial proportion of the shares must not be sold to any person connected with any of the sellers. The relevant shares must be in a trading company or a company which controls a trading company, i.e. a holding company.

- ***Shares earmarked for unapproved options granted by a third party e.g. an EBT (s554L)***. This gateway is separate from the gateway for unapproved options (see below). It will essentially apply where the options are granted within three months of the shares being earmarked for them and then the options being exercisable within 10 (increased from five) years of grant. There are a number of other detailed conditions. The options must not be exercisable if specified conditions are not met; and there must be a reasonable chance the option would not be exercisable at all. The number of shares earmarked must not exceed the maximum number that can be expected to be reasonably needed for the arrangements. Failure to grant the option within three months of the earmarking will trigger a taxable event at the end of the three months if the shares continue to be earmarked. An EBT holding shares 'earmarked' for options or share incentives will need to be sure that it is not caught. The conditions attaching to this gateway seem

to be designed to preclude the use of contrived arrangements for selected individuals under which an EBT or a third person holds shares without giving rights to the individual intended as the beneficiary. However, EBTs with surplus assets or shares in them would need to take care. Upon the occurrence of a relevant event, the overfunding of the EBT may result in the gateway being blocked unless the EBT can demonstrate to HMRC's satisfaction the expected use of the surplus assets or shares, or take other steps to meet the conditions for this gateway.

- ***Options linked to an exit event (s554M)*** – a separate gate way was introduced at the Committee stage for such options. It seems to accommodate private companies which grant options the exercise of which is linked to an exit event. Again, there must not be any connection with a tax avoidance arrangement. Sections 554K to 554M are drafted in a very similar style. It seems subtle differences in the circumstances they cover necessitated repetition of almost identical provisions. For this gateway to be available, the main purpose of the terms of grant must be to ensure that the option is exercisable only if a specified exit event or an event with a specified description occurs. Following the change to s554H mentioned above in connection with good and bad leaver provisions, it seems that such good and bad leaver provisions may be included, but there is no express confirmation to that effect in the drafting. There are extensive provisions to cover situations if an expected grant of options does not take place and shares continued to be held by the relevant third person. Those provisions could trigger a later tax charge. The options must be exercised within a period of six months following an exit event. If the scheme rules provide for a shorter exercise period, that shorter period displaces that six month period. In the case of a flotation, the exercise period may be up to five years, presumably to cater for any lock in period which may be imposed as part of a flotation.

- ***Unapproved options, restricted securities and certain other acquisitions of employment related securities.*** S554N provides perhaps the most an important gateway for unapproved options and acquisitions of employment related securities by employees and directors. Broadly, the acquisition of securities subject to restrictions which cannot last more than five years, the grant of unapproved options (it seems, whenever exercisable) and specified chargeable events under Part 7 ITEPA which give rise to employment income of A would

be protected under s554N. At the Committee Stage, protection was added for securities acquired for market value where the consideration is paid at or about the time of the acquisition and not left outstanding by loan or upon the exercise of unapproved options which give rise to an income tax charge. The later disposal of securities acquired for market value combined with a valid election under s430 or 431 ITEPA should be protected under section 554N. S554N(11) added at the Committee stage also excludes Part 7A applying to relevant steps taken after the acquisition of securities where the subject of the relevant step is the relevant asset (i.e. securities, interests in securities or a securities option) provided there is no connection with a tax avoidance arrangement. There is also a gateway for loans made to employees enabling them to exercise options, provided there is no connection with a tax avoidance arrangement. It should be noted that in the event that a particular relevant step does not fall within the terms of s554N, where consideration is given for the step, that step may be protected in whole or in part under the secondary gateway described below under the heading 'consideration given for the acquisition of securities, interests in securities and securities options'.

This gateway is likely to be of interest to the private equity sector of the market. It is considered that well established techniques involving ratchets and reverse ratchets are capable of passing through this gateway provided they are not connected with a tax avoidance arrangement. Although such arrangements are structured in a tax efficient manner, HMRC has in the past recognised commercially justifiable arrangements such as those within parameters agreed in the Memorandum of Understanding between HMRC and the British Venture Capital Association. Current share incentives in vogue, such as growth shares and joint share ownership schemes can also pass through this gateway, subject to their precise terms. In each case it will be necessary to analyse Parts 7 and 7A with other relevant provisions in ITEPA and other related legislation.

- ***Employee car ownership schemes:*** Employer operated employee car schemes are not caught by Part 7A. This is confirmed by HRMC's reply to FAQ3. A loan provided by a trust, would be caught. There is a gateway for loans provided by licensed lenders. The loan must not exceed a period of four years. The exemption from Part 7A extends to the purchase and sale back of the car under the car ownership arrangement.

- There are separate gate ways for ***employment income exempt under Part 4 ITEPA***, income from earmarked assets, essentially where the earlier earmarking was within Part 7A and acquisitions out of earmarked assets again essentially where the original earmarking was within Part 7A. These gateways are generally relatively narrow. The scope of Part 7A combined with this exemption illustrates that the government recognised the provision of a wide range of employee benefits through third parties, principally EBTs. Those are being curtailed unless they fall within specific exemptions.

- There are exclusions for ***registered pension schemes***, employee contributions to pension schemes and certain other pension schemes including certain foreign pension schemes. The Government's stated aim is to ensure that ***EFURBs***, which were generally more flexible than tax approved pension arrangements and tax efficient, are not more tax advantageous than registered pension schemes with their reduced annual and lifetime allowances. Many in the pensions industry acknowledge that the future use of EFURBs is at least severely curtailed and that EFURBs in their former shape are unlikely to be created in general terms. Therefore any similar arrangement must be tested against the detailed rules. The bigger practical issue is what, if anything, needs to be done with existing structures? There are tightly circumscribed exclusions for certain existing arrangements and accrued rights and obligations. The enduring nature of retirement benefit schemes means that existing arrangements will span the old and new regimes. Accordingly, there are provisions for pre-6 April 2011 annuity rights and lump sum rights and apportionment of sums on a just and reasonable basis. FAQ48, for example, addresses the issue of increases in the value of existing funds and confirms that any apportionment on a just and reasonable basis will vary according to individual circumstances.

(iv) Secondary Gateways

A relevant step may give rise to taxable employment income and not escape through any of the gateways described above. However, the taxable amount may be reduced under the computational provisions relating to Part 7A. Those provisions are described in this article as secondary gateways, which fall into the following categories.

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- ***Non-residence and non-UK duties*** – non-resident employees with a mixture of UK and non-UK duties may be within the scope of UK income tax. A relevant step relating to such an employee has to be tested for links (on a just and reasonable basis) to duties performed in the UK and outside the UK. In principle to the extent the relevant step relates to duties performed outside the UK, the taxable amount is reduced.

- ***Overlapping relevant events*** – the taxable amount linked to two or more relevant steps is reduced for the later relevant event by any overlapping amount attributable to an earlier relevant event which was within Part 7A. The amount of the overlapping amount is assessed on a just and reasonable basis where it is not the whole amount.

- ***Consideration given to exercise an option*** - the value of a relevant step is reduced by the amount of money A has to pay on the exercise of an certain options, which broadly are granted over earmarked shares under an employer's scheme by a third party such as an EBT.

- ***Consideration given for the acquisition of securities, interests in securities and securities options*** - where the employee pays for such securities by assets or money at or about the time the securities are acquired, broadly, the taxable amount of the relevant event is reduced by the amount paid or the value of the asset given in exchange. There must be no connection with a tax avoidance arrangement where the consideration is in the form of an asset. There is assumed to be such a connection where the asset was transferred to the employee by another person by way of loan or the asset or related rights are connected with the relevant arrangement. The consideration must be given by A "in the form of the transfer of an asset to P from A" or the payment of a sum of money to P by A. In contrast to the new s554N (8), there is no express reference to money's worth form of consideration. The requirement of a transfer of an asset or payment to P from A at or about the time of the relevant step excludes consideration given in the form of a promise to pay. Deferred consideration therefore appears to be outside the scope of this secondary gateway. Where the deferred consideration is in fact later paid, there is no specific provision to relieve the earlier tax charge. The absence of such relieving provision could give rise issues of the proportionality of these measures (see below).

Finally, nil paid shares subscribed by an employee or director in its employer company or the group parent company should not be within this category of issues provided it is established that the person form whom the shares are acquired is not a relevant third person.

- ***Remittance basis*** – non-domicilaires who claim the remittance basis for the years related to the relevant step can have the taxable amount apportioned to relevant tax years on a just and reasonable basis and pay tax on any remitted amounts of income which relate to duties performed outside the UK.

Tax avoidance arrangement and connected steps

A person being party to an arrangement whose main purpose, or one of the main purposes for entering into the arrangement is the avoidance of tax or national insurance contributions makes the arrangement a tax avoidance arrangement. A step is connected with a tax avoidance arrangement if it is taken pursuant, either to that arrangement or another arrangement which is part of a series of arrangements linked to the tax avoidance arrangement. It does not matter that the person taking the step is unaware of the tax avoidance arrangement. This language is clearly very broad. Its precise impact can only be tested against a given set of facts.

This legislation will inevitably lead to much debate on the future use of off shore trusts as employees' benefit trusts. It is considered that off shore EBTs used for share incentives would survive under the new legislation unless they are used for tax avoidance considered to be unacceptable. This is implicit in the amendments made to the draft legislation, for example, in section 554E (7), which essentially recognise that shares may be held for an EMI arrangement for up to ten years. Although there is no express reference to trusts or their residency, HMRC can be expected to know that many trusts are established off shore. Such EBTs often serve important non-tax functions such as allowing existing shares to be recycled for options and incentives, where employees leave and their awards lapse. Those EBTs are not normally artificial structures. At a simplistic level the decision to have an off shore trust with a view to ensuring that any contingent capital gains are not subject to capital gains tax may be perceived as a tax avoidance motive. However, when the trust is set up, when it does not have any assets, any tax avoidance motive would be remote. Further, fundamental freedoms of establishment and the free movement of capital under the Treaty on the Functioning of the European Union should allow EBTs to be set up off shore, including

outside the European Union, for example in the Channel Islands.

(v) The taxable amount

The taxable amount is the value of the relevant step. Where the relevant step "involves" a sum of money, the taxable amount is the sum of money. In any other case, the taxable amount is the market value of the asset the subject of the relevant step when that relevant step is taken or, if higher, the cost of the relevant step. The cost is ignored in relation to the acquisition of securities where chapters 2 to 4A of Part 7 of ITEPA apply by virtue of the acquisition or where the secondary gateway described above in relation to options applies.

References to relevant steps which "involve" money are defined. Money which is the subject of an allocation event within s554B (earmarking or being held, in each case with a view to a later relevant step being taken) gives the relevant step the characteristic of involving money. Otherwise the step must involve the payment of money or the making available of money. A loan made by the payment of money would be a relevant step which involves money. The sale of an asset, such as securities, for deferred consideration would not, it appears, fall within s554C, but may fall within s554B. On specific facts, it may be arguable that such a sale does not constitute a relevant step which involves money as defined.

For other cases, the market value provisions in TCGA 1992 are adopted without any amendment. Where assets are earmarked or made available, it appears their full market value is taken as the taxable amount. Broadly, although the case law on the statutory market value postulates a hypothetical value, the value is nevertheless determined by reference to the price a buyer would pay to enjoy whatever rights attach to the asset in question on the relevant day (*IRC v Gray* [1994] STC 360). Further, the value must have regard to the actual facts and circumstances (*Walton v Commissioners of Inland Revenue* [1996] STC 68). Essentially the test becomes what a person would pay to enjoy the fact of assets having being earmarked or made available. It remains to be seen whether valuation experts assign material value to such relevant steps. This perhaps illustrates the significance of the reference to the higher cost, which may be more readily ascertainable. The references to cost must be ignored in relation to securities, therefore, in relation to securities being made available, the valuation issue mentioned would remain to be tested.

HMRC's reply to FAQ15 confirms widespread concern that there is no provision for credit to be given where a loan made after 6 April 2011 is repaid except in limited circumstances.

By contrast, a loan which was made on or after 9 December 2010 and repaid before 6 April 2012 would reverse a tax charge. The rational for the difference of treatment of those loans is not immediately obvious. There will be a further contrast between the treatment of beneficial loans made by an employer and third party loans caught under Part 7A. Conceivably charges under Part 7A will appear inequitable and disproportionate in certain circumstances. Challenges to Part 7A charges in such circumstances under the Human Rights Act 1998 cannot therefore be ruled out. Although most cases on the Human Rights legislation in the tax context have related to tax evasion, there are other authorities of relevance. The challenge to the IHT legislation in *Burden and another v United Kingdom* [2007] STC 252 (and [2008] STC 1305) was unsuccessful partly on the grounds that the UK, like other contracting states, has a wide margin of appreciation in enacting tax legislation. The challenge to the IR35 legislation (*R (on the application of Professional Contractors Group Ltd and others) v Inland Revenue Commissioners* - [2001] STC 629) was found not to be disproportionate as its purpose was to counter tax avoidance and the diminution of tax revenue. Those cases referred to the overriding principle that the legislation must demonstrate a 'reasonable relationship of proportionality between the means employed and the aims pursued'. It is suggested that the essential issue for the charge under Part 7A would be whether it is proportionate to the economic benefit accruing to employees from the repayable loans or assets made available, taking account of the objective to deter the use of unacceptable tax avoidance devices. The answer to such a question rests in the competence of the courts.

As mentioned above, the taxable amount can be adjusted under various provisions, for example those described as the secondary gateways above.

(vi) Paying the tax

It was mentioned at the outset that Part 7A seeks to impose an income tax and NIC charges at the time of the earliest relevant event which does not pass into a safe harbour through a gateway. The tax and NIC must be paid under PAYE. NIC regulations have yet to be introduced, although draft regulations have been published. The tax must be paid by the employer unless the person providing the reward deducts it at source and accounts for it. There are special provisions to deal with the death of the employees or relevant person concerned.

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PAYE must be operated in respect of non-monetary assets whether or not they are readily convertible assets. The value of the relevant event giving rise to the tax charge counts as the payment of PAYE income for PAYE purposes except to the extent the remittance basis applies. The PAYE must be calculated by reference to the "best estimate which can reasonably made" (s695A ITEPA introduced by para 31 of Schedule 2 FA 2011).

The draft NIC regulations are short. They provided that amounts chargeable as income under Part 7A are treated as earnings for NIC purposes. Amounts caught as income under the anti-forestalling provisions of Schedule 2 FA 2011 are excluded from the charge to NIC. The regulations recognise that in certain circumstances the same amount may be subject to NIC more than once, so they provide for exclusions to avoid double taxation.

PAYE will in most cases have to be accounted for in the normal manner by the 14th day after the end of the month in which the relevant event gives rise to a charge to tax. Where the relevant step took place before the Finance Act 2011 was passed, the payment was treated as made on the 30th day after the Act receives Royal Assent i.e. on [18] August 2011. In the case of prospective employees, payment is treated as made on the day B's employment starts.

Failure to recover PAYE from the employee within 90 days will create double taxation under s222 ITEPA.

CONCLUSION

The mischief Schedule 2 of the Finance Act 2011 aims at is "third party arrangements [which] allow an employee to enjoy the full benefit of a sum of money or assets provided while arguing that, because of the structure of the arrangements, there is no legal right to the money or assets" thereby avoiding or deferring tax and national insurance contributions. The Government originally estimated that it expects to collect £500 million per year. The £500 million was changed to £750 million by the time the Finance(No.3) Bill 2011 reached the Committee Stage. HMRC said they knew about approximately 5,000 employers using the arrangements which provided benefits for approximately 50,000 employees and which could be affected by Part 7A. The arrangements broadly involve EBTs and EFURBs, which achieve deferral regarded as unacceptable by HRMC. Part 7A recognises the widespread use of EBTs for inoffensive structures, often concerning share incentive schemes. The

gateways will allow businesses to provide benefits to employees in the ordinary course, including share incentives. However, merely the number of provisions and the scope of the new rules will cause concern to businesses. There will inevitably be some cost to businesses adopting commercially justifiable arrangements which do not pass through the gateways.

For more information on Tarlochan Lall contact the Clerks on +44 (0)207 405 7211 or consult the 'Find a Barrister' section at www.monckton.com.

Monckton Chambers
1 & 2 Raymond Buildings
Grays Inn
London, WC1R 5NR

Tel: +44 (0)20 7405 7211
Fax: +44 (0)20 7405 2084
Email: chambers@monckton.com
www.monckton.com