BRIEFING

Disguised remuneration schemes and the Loan Charge

Introduction

The imposition of the loan charge in 2019, which aimed to deal with a form of disguised remuneration tax avoidance scheme, has been one of the most controversial pieces of tax legislation introduced in recent years.

With up to 100,000 people being impacted by the charge, and many facing life changing tax bills which they did not expect to pay, it is natural that there has been a passionate debate on the issue.

This briefing focuses on presenting some of the facts with regards to loan schemes, the loan charge, and tax law relating to disguised remuneration schemes.

The debate on the Loan Charge has covered a wide range of issues, including whether or not employees were compelled to take part in tax avoidance schemes by their employers, and issues of fairness in relation to the treatment of scheme users by HMRC.

Although these issues are very important, they are not issues which we have expertise on and so we have not focused on them in this document.

In order to understand how these loan schemes operated, we draw on cases brought under the disclosure of tax avoidance scheme legislation (DOTAS). DOTAS only requires scheme operators to notify HMRC of the scheme. In recent years HMRC has brought several cases against loan scheme promoters for not disclosing their schemes. Notification does not determine whether a tax avoidance scheme is lawful or not. However, the DOTAS cases do provide useful evidence on how loan schemes worked in practice.

What is disguised remuneration?

For as long as governments have sought to tax the income that individuals receive from their work or investments, people have sought to avoid paying that tax.

Disguised remuneration schemes are a form of tax avoidance where payments arising from employment are made in some form other than cash or to a person who is not the employee. In the past disguised remuneration schemes have been set up to pay employees in fine wines or diamonds, or have involved making payments to a trust established to benefit family members.

These payments are not declared as income in the tax returns of the employee or contractor and so no income tax is paid. If the employee is paid via PAYE, then no income tax is withheld by the employer on behalf of the employee on the part of the remuneration that is disguised.

What are loan schemes?

Loan schemes are a particular kind of disguised remuneration tax avoidance which involves the payment of employment income in the form of loans. The loans were made on very favourable terms which would not be available on a commercial basis. Often these loans were made via an offshore trust set up by scheme promoters.

A typical loan scheme would see payments made into a trust by the employer, which would then loan money to the employee, often with a series of intermediary steps that created increasing degrees of complexity in the transaction. The scheme operator would take a cut of payment as a fee for operating the scheme.

On paper the loans are real in that they involved entering into a loan contract, and in theory the money could be recalled. **In practice no one would enter into such an arrangement if they thought there was any chance the loans would need to be repaid.**

In one tribunal case from January 2019 brought under DOTAS legislation reference is made to an FAQ which included the question "*is there any risk I will have to repay the loan?*", to which the answer was "*the loan is received as a benefit & can be written off at any time. Although for IHT [inheritance tax] purposes the participant may wish to leave the loan in place*".[1]

In another scheme that has come before the courts, there was no written material which stated that the loans would not be repaid. However, the loan was to be issued for 20 years by a trust set up to provide rewards to employees.

1 HMRC vs Curzon Capital Ltd (26 Jan 2019).

At the end of that period the duration of the loan could be extended further into the future. The loan could only carry interest at the discretion of the trustees.[2]

In that case, the judge went onto make the finding that although it was never written down that the loan would not be repaid, that this must have been the intention of the scheme and all parties will have entered into the scheme on that basis.[3]

Who benefits from loan schemes?

There are wildly different figures presented for how much tax was avoided by loan scheme users. The promotional material for one scheme showed how using it could allow for the retention of 82% of gross earnings. The remaining 18% was paid out in fees to the various people involved in operating the scheme.

According to the same material an employee not using the scheme would normally expect to keep between 52%-65% of their earnings after tax was paid.

On the basis of a salary of £100,000 that represents up to £30,000 a year of tax avoided.

On top of this there was a potential to generate 27% savings on inheritance tax as loans could be left in place until death and written off against any assets in the estate of the deceased.

The employer saved 13.8% on National Insurance contributions, and get Corporation Tax relief on the payments made.[4]

The only cost was the fees taken by the scheme operators. No tax was paid.

The fees appear to have been a fixed proportion of the amount put through the scheme. This means that higher rate tax payers stood to benefit much more from using these schemes than basic rate taxpayers. Indeed some schemes were marketed as being "effective for employees earning over £45,000 per annum".[5]

For this reason it is unlikely that basic rate taxpayers will have pursued such schemes. However, **there is evidence that some lower paid workers were compelled to enter schemes by their employers,** who would have stood to gain substantial amounts through not paying employer's national insurance.

2 HMRC vs EDF Tax Limited (20 September 2019).
3 Page 7, HMRC vs EDF Tax Limited (20 September 2019)
4 HMRC vs Curzon Capital Ltd (26 Jan 2019).
5 Ibid.

Are disguised remuneration schemes legal?

One of the central arguments against the loan charge is that loan schemes are a form of "legal" tax avoidance. This is misleading.

Tax avoidance is not a criminal offence. However, that does not mean that a tax avoidance scheme is effective in terms of tax law.

Under long established legal principals HMRC and the courts are able to disregard the effect of tax a avoidance scheme when it comes to applying tax law if the scheme is found to have no commercial purpose other than to take advantage of the tax system in a way that was never intended by Parliament.

In other words, tax professionals cannot seek to exploit a loophole in tax legislation and expect to gain the benefit of it.

This is what HMRC mean when they say that tax avoidance schemes are "ineffective" in law or that schemes "no not work".[6]

One of the key questions with regard to any tax avoidance scheme is: what is the real purpose of the transactions that make up the scheme? For disguised remuneration schemes, the question will be whether or not the real purpose of any transaction is to reward an employee for services provided in an employment relationship.

In the case of loan schemes, the key issue will be whether or not the loans were real loans or simply transfers of earnings dressed up to look like loans. If the loans were created purely for tax avoidance purposes, they would not be exempt from income tax.

As set out by Lord Upjohn in *Heaton vs Bell*, a case from 1970, 'having ascertained the real nature of the transaction, you cannot ... disguise it by using camouflaged clothing'.[7]

The Big Tax Case

Between 2001 and 2010, more than £47m was paid to players, managers, and directors of Scottish football club Glasgow Rangers in tax-free loans. These loans were made via an offshore trust, which had been created in order to provide the impression that the loans granted were independent of the club. It was part of the

6 For a more detailed discussion of the law with regards to tax avoidance see the TaxWatch briefing: Is Tax Avoidance Legal? Available from: https://www.taxwatchuk.org/is_tax_avoidance_legal/

7 Heaton v Bell [1970] AC728, 760E

player's pay agreements that the club would make payments into the trust on their behalf.

After a long legal battle with both sides claiming victory in the lower courts and the Court of Session in Scotland, the case went to the Supreme Court in 2017, which found in favour of HMRC. It is now considered the leading case in the area of disguised remuneration.

In the Court of Session, the court reviewed case law looking at tax avoidance and disguised remuneration going back to 1904. Lord Drummond, giving the judgment made the following observation:

> "The fundamental principle that emerges from these cases appears to us to be clear: **if income is derived from an employee's services *qua* employee, it is an emolument or earnings, and is thus assessable to income tax, even if the employee requests or agrees that it be redirected to a third party.** That accords with common sense.
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> This principle is ultimately simple and straightforward – indeed, so straightforward that in cases where elaborate trust or analogous relationships are set up it can easily be overlooked.[8]

The legal advice around loan schemes

It is very clear from the evidence emerging from the courts and from evidence submitted by people involved that the schemes were constructed by senior lawyers and accountants.

According to HMRC, early iterations of loan schemes were marketed by big four accountancy firms.[9] Some were marketed as "QC approved". This was obviously designed to give users reassurance that what they were doing was lawful.

It should be noted that legal advice is not the law. Lawyers frequently provide advice which turns out to be incorrect. If they did not, there would be very little need for litigation of any kind.

However, serious questions remain for the legal, tax and accountancy professions as to how their members were able to sell such schemes.

8 The Advocate General for Scotland vs Murray Group Holdings para 56, available from https://www.scotcourts.gov.uk/search-judgments/judgment?id=8213f5a6-8980-69d2-b500-ff0000d74aa7

9 The UK Government's entry into the OECD's aggressive tax planning database on disguised remuneration schemes states that these schemes were originally promoted by Big Four accountancy firms. The entry in the database is not available to the public but was leaked by Loan Charge campaigners.

Paul Baxendale Walker, the architect of the Rangers loan schemes, was struck off by the law society in 2006, but still was providing advice to Rangers on the operation of their schemes for years afterwards.[10]

In the tax field new professional guidance adopted by all professional bodies require their members not to create or promote any arrangements which seek to defeat the intention of Parliament when making tax law. However, in the UK, according to the Association of Accounting Technicians, around one in four tax advisers is not a member of any professional body and therefore has no obligation to follow any professional guidance.

Although it is frequently claimed by scheme users that they were told that the schemes they used were all perfectly legal, it is also clear from the evidence that some promoters did tell their clients that there was at least a possibility that these schemes would be challenged by HMRC.

In one scheme before the courts, it was revealed that users received a letter which stated "*...HMRC may enquire into this planning and it may at some point be the subject of litigation*".[11]

In a tribunal decision from September 2019, it was revealed that users paid into a legal defence fund, *Defence Services Limited*, which was set up specifically to fund future challenges by HMRC against the effectiveness of the scheme.[12] It is difficult to understand why it would be deemed necessary to pay into a legal defence fund if the schemes were completely "legal".

What is the loan charge?

The Loan Charge was introduced in the Finance Act 2017 and places an income tax charge on the value of outstanding loans on 5th April 2019 held by people who have used disguised remuneration schemes. As originally drafted the loan applies to any loan entered into since 1999.

The Loan Charge seeks to get around the issue of whether the loans issued were 'real' commercial loans or not by putting the charge on outstanding loan balances at a date in the future. If the loans were real, then scheme users will have taken

10 A description of Mr Walker's involvement in the Rangers Tax Avoidance Scheme is given in the dissenting opinion of Dr Poon in the First Tier Tribunal in Murray Group and Others vs HMRC.

11 Page 7, HMRC vs EDF Tax Limited (20 September 2019)

12 HMRC vs EDF Tax Limited (20 September 2019).

steps to provide for their repayment at some point and not spent the money as earnings.

Retrospective legislation

One of the strongest criticisms against the Loan Charge is that it is retrospective taxation and so is not commensurate with human rights law. HMRC argue that the loan charge is not retrospective as it places a new tax on outstanding loans on a date after the passage of the relevant legislation.

Ray McCann, the then President of the Chartered Institute of Taxation in evidence to the Treasury Select Committee, stated that in his view, the loan charge is worse than retrospective legislation in that all of the outstanding loans are rolled up into one year.[13] If the charge was retrospective then it would add to the income tax liability of the scheme user in every year they used the scheme rather than in one year.

The charge being placed in one year means there is a likelihood that for some users the charge could be higher than the actual tax avoided, as the taxpayer may have had years where they did not earn enough to pay the higher rate of tax, but by putting all of their income in one year there is a very high likelihood that the charge would bring them into the higher rate tax band.

It also circumvents the usual taxpayer protections, most importantly, the limits placed on the tax authority as to how far they can look back at previous tax years. Usually the time limit is six years, but that can be extended to 20 years if HMRC believes there has been a deliberate attempt to hide information from them.

The Loan Charge, as originally drafted, would have allowed HMRC to collect tax on loan schemes from 20 years ago, even in circumstances where people had declared their involvement in a tax avoidance scheme.

Tax and human rights

It should be noted that when it comes to tax, retrospective legislation is neither unprecedented or unlawful with regards to human rights law.

In 2004 the then Paymaster General Dawn Primarolo introduced a set of legislation designed to combat disguised remuneration schemes. Alongside the legislation a written statement was made that the government would seek to

13 Oral evidence: The conduct of tax enquires and resolution of tax disputes, HC 733, Question 98

close down new schemes as they became aware of them, and were prepared to use retrospective legislation to do so.

The statement said the following:

> "Experience has taught us that we are not always able to anticipate the ingenuity and inventiveness of the avoidance industry. Nor should we have to. Our objective is clear and the time has come to close this activity down permanently.
>
> I am therefore giving notice of our intention to deal with any arrangements that emerge in future designed to frustrate our intention that employers and employees should pay the proper amount of tax and NICs on the rewards of employment. Where we become aware of arrangements which attempt to frustrate this intention we will introduce legislation to close them down, where necessary from today."[14]

The notice given to the tax avoidance industry was ignored and the government did go onto introduce retrospective legislation in the Finance Act 2008. Section 58 of that Act sought to close down a disguised remuneration tax avoidance scheme involving Isle of Man partnerships, by retrospectively stating that tax treaties would not apply to certain types of income. The legislation was challenged in both the Court of Appeal and the European Court of Human Rights. Both found in favour of the government.

In the Court of Appeal, Lord Justice Mummery supported the idea that retrospective legislation could be used to negate the effect of tax avoidance schemes and made the following observation:

> "In the circumstances of this case, the liability of the claimant under the retrospective legislation of s.58 to pay the UK income tax that he would have had to pay, if he had not participated in the tax avoidance scheme, is no more an unjustified interference with his enjoyment of his possessions than the ordinary liability that his fellow residents in the UK are under to contribute, by way of UK tax on their income, towards the costs of providing community and other benefits for the purposes of life in a civil society."[15]

14 HC Deb 2 December 2004 cc44-46WS
15 R vs HMRC [2011] EWCA Civ 893 paragraph 94

Loan schemes were drawn up by professional lawyers and accountants who certainly should have been aware of important statements of government policy and case law at the Court of Appeal. They should have warned their clients about the real risks in engaging in tax avoidance schemes, including the risk that they would be closed down via retrospective or retroactive legislation with any tax avoided payable in the future.

Why impose a loan charge?

If HMRC were convinced that loan schemes were always ineffective, then why implement the loan charge at all? Why not pursue scheme users via the usual processes?

HMRC estimate that 50,000 people would have been impacted by the loan charge as it was originally drafted. Loan Charge campaigners say the figure is more likely to be 100,000.

What is clear is that despite HMRC and the Inland Revenue before it being aware of these kinds of schemes from the early 2000s, not enough was done to deal with the issue over a long period of time. By 2019 a huge backlog of cases had built up.

Giving evidence to the Treasury Select Committee, David Richardson, the Interim Director General of Customer Strategy and Tax Design at HMRC said that there were 105,000 open cases relating to marketed tax avoidance schemes, of which 80,000 were unresolved. The cases had been open from between five to twelve years.[16] Disguised remuneration schemes were one form of marketed tax avoidance schemes, but there have been others, such as film schemes.

There are a number of reasons why this backlog built up. The sheer number of schemes was one factor. In 2005-06 HMRC was notified of 600 schemes under the DOTAS regulations. Many more would have gone unnotified. It is also the case that scheme operators aggressively defended the use of such schemes, refusing to co-operate with HMRC, and as has already noted, some had built up legal defence funds to fight them through the courts. Some scheme operators were set up as limited companies offshore and simply disappeared as soon as HMRC started investigating them.

16 House of Commons Treasury Select Committee, *Disputing Tax*, Thirty-Fourth Report of the Session 2017-19, paragraph 8.

The legal process to challenge a scheme can be long and cumbersome. The Big Tax Case case took 13 years to resolve from the point where HMRC opened an enquiry into the tax affairs of Rangers Football Club, and between 2012 and 2015 the courts found against HMRC. Those judgments will no doubt have reassured some scheme users that the course of action they were taking was lawful.

In addition to the difficulty in progressing these kinds of cases through the courts, particularly when the taxpayer is being uncooperative with HMRC officers, it should be noted that the increase in the backlog occurred over a period when HMRC was subject to significant staffing cuts. When HMRC was created in 2005 the department had around 93,000 staff.[17] Today that number is 66,000.[18] The 2018-19 financial year saw HMRC with a budget of £4bn,[19] less in cash terms than when the department was created in 2005-6.[20]

Conclusions

Overall, The Loan Charge scandal illustrates the dangers to the fair and effective administration of the tax system when the authority responsible has insufficient capability and resource to deal with a major threat.

It is clear that loan schemes are a form of tax avoidance, the purpose of which was to allow scheme users to get out of paying large amounts of tax.

Long established legal principles should have made it very clear that these schemes were not lawful in terms of tax law. However, legal professionals, accountants and tax advisers marketed these schemes regardless.

A failure to take action early on, and the aggressive behaviour of some tax and legal professionals in marketing these schemes and defending them, led a huge backlog of cases.

This led to a situation where HMRC and the government have sought to legislate away the problem, and in the process have bypassed long established taxpayer protections such as time limits on how far HMRC can pursue taxpayers for unpaid tax.

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17 Page 54, shows 92,888 "full-time equivalent (FTE) staff" for 2005-06, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/243210/6983.pdf
18 https://www.gov.uk/government/organisations/hm-revenue-customs/about/recruitment
19 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/824652/HMRC_Annual_Report_and_Accounts_2018-19__web_.pdf
20 2005-06 budget of £4.413bn, https://publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/731/73105.htm

It is undeniable that the long time it has taken to deal with this issue has caused real hardship amongst some scheme users, regardless of their intentions of joining such schemes in the first place.

The proposals in the Morse review seek to find a way through these difficult issues. It is up to Parliament to decide whether the right balance has been struck.

However, it is also important for Parliament and society more widely to consider the serious issues arising from this scandal. From the conduct of tax professionals in selling these schemes, to the failure of HMRC, for whatever reason, to deal with tax avoidance schemes in an efficient and timely matter.

No one would benefit from a return to the days when a large part of the tax profession saw it as part of their job to undermine the tax system, and tax avoidance on the part of highly paid employees and contractors was seen as a socially desirable activity.

If we are to ensure that this does not happen in the future, Parliament must satisfy themselves that lessons have been learned.

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