Employee benefit trust arrangement: careless and deliberate conduct

Employment Tax | Management of taxes



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We examine how the First-tier Tribunal viewed HMRC's allegations of careless and deliberate conduct in the context of an employee benefit trust arrangement.

Key Points

What is the issue?

Delphi Derivatives Ltd was a successful company trading in futures and options on the London Metal Exchange which entered into a series of arrangements with the purpose of transferring bonuses to its directors.

What does it mean to me?

The adviser’s letter to his clients before they chose to proceed was carefully scrutinsed to determine to what extent the directors had acted carelessly or deliberately. A key argument they were putting forward was that they had reasonably taken professional advice.

What can I take away?

The case provides a good reminder of how the paperwork trail leading to (and following) any one-off arrangement could be closely examined in a tribunal many years down the line.

The attempts of employees (typically, directors) to extract funds from their companies in a tax-efficient fashion and the attempts of the authorities to thwart such arrangements are likely to provide plenty of material for PhD theses for many years to come. The fact that such arrangements were then industrialised and (mis)marketed to contractors leading to, amongst other matters, the loan charge – and the catastrophic impact which that had on the contractors involved – only adds to the potential material in this area.

A further area worthy of examination at some future date will be an analysis of judicial attitudes in the context of such arrangements. This article considers one recent case which might well feature in any such further study, *Delphi Derivatives Ltd v HMRC* [2023] UKFTT 722 (TC).

The facts of the case

Delphi Derivatives Ltd (Delphi) was a successful company trading in futures and options on the London Metal Exchange.

During the years ended 5 April 2009 and 2010, the company entered into arrangements which had the purpose of transferring bonuses to its directors. The arrangements were entered into on four occasions: three tranches in the 2008/09 tax year and one in the 2009/10 tax year.

Under the arrangements, a Jersey-based human resources consultancy ('the consultant') would prepare a report for Delphi recommending that it should make a payment of bonuses to its directors, and also suggesting an amount to be paid. On the same day, the consultant would issue Delphi with an invoice for preparing the report, which would be for the same amount as the suggested bonus.

Following Delphi's settlement of the invoice, the consultant would then settle a substantial proportion of its fee (i.e. net of its own profit element) into an employee benefit trust for the benefit of the directors. The trust would then advance funds to the directors in the form of loans. The purpose of making loans to the directors, rather than outright payments, was to ensure that the sums advanced would not be subject to PAYE and NICs. Instead, the sums advanced would attract, at most, the income tax rates for employment-related loans, albeit on an annual basis.

The form of the arrangement was to ensure that, as well as giving the funds to the directors in a tax-efficient form, Delphi would get the benefit of a corporation tax deduction in relation to the calculation of its trading profits.

Ordinarily, the Corporation Tax Act 2009 s 1290 (previously, the Finance Act 2003 Sch 24) precludes such a deduction unless the funds are then applied in the payment of taxable income. In other words, a company could get an allowable expense but only if tax was payable by the directors in relation to any payment. However, this restriction on the corporation tax deduction is disapplied if the funds are 'consideration for goods or services provided in the course of a trade or profession'.

The logic underlying the scheme, therefore, was that the payment by Delphi represented a fee for the consultant's services, even though in reality the fee retained by the consultant was substantially less and the majority of the payment would find its way into the trust.

Before entering into the arrangements, Delphi's tax adviser was consulted. He was allowed to view the QC's opinions that the scheme promoters had obtained, which supported the efficacy of the arrangements.

The adviser duly wrote to the company's directors. In his letter, the adviser pointed out that:

- the scheme has the merit of simplicity;

- the scheme uses an express exemption within the employee benefit trust rules;
- ordinarily, the payment by the company directly into a trust would not allow a corporation tax deduction to be obtained but paying for subcontracted services 'appears to circumvent the rules'; and
- the effectiveness of the scheme represents the opinion of 'a well respected QC'.

The letter also contained a number of warnings:

- There was a risk of the arrangements being tackled via retrospective legislation.
- There was a risk that prospective legislation would be introduced to block such arrangements, meaning that the company might have had only a limited time to act.
- There was a risk of an inheritance tax charge because of the use of a trust.
- It was necessary to ensure that the company's VAT position did not mean that VAT payable on the fees to the consultant would not be fully recoverable.

Within those warnings, it was also noted that, if HMRC were successful in challenging the corporation tax deduction, the tax-free nature of the income in the directors' hands would make the tax savings of the scheme 'only marginal'.

The adviser also noted that, in cases such as this, he would usually recommend that his client obtain independent counsel's opinion. Although he was of the view that this arrangement had 'a stronger chance of success than many more convoluted schemes', this remained his advice 'considering the amount you may wish to place in these arrangements'.

Finally, the letter concluded by stating that the adviser could 'not formally recommend such a scheme … as there is certainly a risk in entering such arrangements'. However, it then went on to warn the directors that if they wished to proceed having taken a commercial view, he would assist them in ensuring that the arrangements were properly implemented.

At approximately the same time, the former Special Commissioners (one of the predecessor tribunals to the First-tier Tribunal) was considering the case of *Sempra Metals*, which also considered the payment of bonuses in the form of loans from an employee benefit trust. In that case, HMRC was successful in denying the employing company a deduction from its trading profits. However, the promoters of the

arrangements provided Delphi with an email to suggest that this should not be taken as a bad sign because there were a number of major differences between Sempra's facts and those of Delphi.

As a result, Delphi claimed a corporation tax deduction for the fees it paid its consultant. Unsurprisingly, however, HMRC opened enquiries into Delphi's corporation tax returns for the two years covered by the contributions.

In due course, HMRC also issued PAYE and NIC determinations in relation to the amounts paid. Over the next couple of years, there was a suggestion that the matters would be resolved via the Employee Benefit Trust Settlement Opportunity or, later, the Liechtenstein Disclosure Facility. In the end, those opportunities were not taken up.

However, following HMRC's 2015 success in the *Rangers* case (then at the Court of Session, after two defeats in the tribunals), it newly became clear that the payments made by the companies should have been subject to PAYE and NICs. In other words, the focus of HMRC's attack now became the obligation to account for PAYE and NICs, rather than the previous worry being the corporation tax deduction. This led the company to reach a settlement with HMRC but such settlement did not cover the question of possible penalties.

Subsequently, HMRC issued penalty assessments against the company for the submission of erroneous P35s (i.e. omitting reference to the payments which were made to the consultant and which were then advanced to the trust). The penalties were issued under the provisions in Schedule 24 to the Finance Act 2007. In respect of the first three tranches (i.e. the 2008/09 P35), HMRC alleged that the errors in the P35 had been due to carelessness; for the fourth occasion that the company entered into the arrangements, HMRC alleged that the errors had been due to deliberate conduct.

Delphi appealed and the case was duly notified to the First-tier Tribunal.

The First-tier Tribunal's decision

The case came before Judge Heidi Poon and Member Mohammed Farooq.

The essence of the company's case was that the directors had taken advice before entering into the arrangements, that they were right to do so and that advice was not obviously wrong. Accordingly, when the company submitted its P35s for the two years, it had taken reasonable care to make correct returns; and therefore any errors in the returns were not due to careless conduct. Furthermore, the company had certainly not submitted the second P35 knowing it to be wrong.

However, the tribunal considered that the statutory words 'due to' should not be interpreted in the sense of causation (i.e. the tribunal decided that the errors in the return did not need to be caused by any specific carelessness). Instead, it held that 'the nexus required to be established is one of attribution in the sense that the inaccuracy can be accounted for by a mode of behaviour which is characterised as a failure to take reasonable care'.

Furthermore, the tribunal put a lot of attention on the agency rules in Schedule 24 para 18. That provides that the penalty rules can operate not just when the taxpayer submits an erroneous document but also when that document is submitted on the taxpayer's behalf by a third party. In such situations, a penalty can be avoided if the taxpayer can show that it took reasonable care to avoid a penalty. The P35s, as a matter of fact, were submitted on the company's behalf. Although the directors could arguably show that they had taken reasonable care to establish the effectiveness of the arrangements, they had not provided any further evidence to show that they had taken reasonable care to ensure that the subsequent P35s were accurate.

The tribunal also focused on the fact that the company did not take up the suggestion that it obtain a second opinion from independent counsel. The company sought to argue that, had they sought a second opinion, it would at the time have agreed with the scheme promoters because until 2015 all the case law suggested that the use of the arrangements would not trigger any PAYE liabilities. The purpose of this argument was to show that the lack of second opinion was not the cause of any subsequent error in the P35s. Instead, the cause would have been the widespread failure (before 2015) to appreciate the need to operate PAYE in such cases. However, the tribunal appears to have likened this defence to a 'prevailing practice' defence, which is occasionally deployed in the context of discovery assessments. The tribunal said that the defence could not be made out because HMRC's objection to these arrangements meant that there was no prevailing

practice concerning them. As a result, the company's arguments on this point were also unsuccessful.

In relation to the allegation of deliberate conduct, the tribunal pointed to the fact that the directors knew that the arrangement was tax-motivated rather than a genuine attempt to obtain independent advice on the appropriate level of remuneration. Indeed, in respect of the fourth tranche, the paperwork made it clear that the amount being paid into the scheme was determined more by the company's directors than the consultant.

As a result the company's appeal was dismissed.

Commentary

The decision is not short – amounting to 269 paragraphs over 78 pages. However, it is clearly written, which makes the reading process significantly easier. Nevertheless, there were a number of aspects that led to a raising of the eyebrows. In short, the decision ought not to survive any appeal and, in the meantime, it would be surprising if other constitutions of the First-tier Tribunal readily adopted the approach taken by the tribunal in this case.

First, the tribunal's interpretation of the words 'due to' seems to deviate from the clear meaning of those words – and, perhaps more relevantly, binding case law authority from the Upper Tribunal (for example, see my article 'Perils of an unauthorised payment' (*Tax Adviser*, July 2020) on the decision in *Bella Figura Ltd* [2020] UKUT 120).

What made the First-tier Tribunal's approach even more surprising is that its analysis started by looking at the rules that pre-dated the Finance Act 2007. Under that previous legislation, there was clear case law showing that there had to be a causal link between the conduct complained of and the error in the relevant tax return. The tribunal proceeded to say that the new statutory wording meant there should be no assumption that the previous case law held good. (Of course, it did not mean that the previous case law was no longer relevant.)

Interestingly, however, the old legislation used the words ‘attributable to’ and it was precisely that wording that required there to be a causal link. Yet when trying to apply a definition to the more modern words ‘due to’, the First-tier Tribunal went and gave it the meaning of ‘attribution’. It is hard to understand why that did not then lead the tribunal to conclude that, after all, the words ‘due to’ should be interpreted in a similar way to the previous words ‘attributable to’.

Secondly, the tribunal seems to have given the agency rules in para 18 a new meaning. On the tribunal’s approach, the normal rule that it is for HMRC to establish careless conduct is turned on its head in any case where a document is submitted to HMRC by a third party. In such cases, according to the tribunal, it is for the taxpayer to prove that reasonable care had been taken. In previous cases, para 18 has been interpreted merely to ensure that a penalty may be charged in instances of careless conduct, irrespective of whether it is the taxpayer or an agent who submits the relevant document.

Thirdly, I cannot see any reason why the tribunal applied the case law on prevailing practice which is a specific defence in discovery assessment cases. In the law of professional negligence, it is usually a defence by a professional to show that they have followed a practice that is widespread within the profession, as long as that practice is not obviously flawed. Had the First-tier Tribunal not applied the case law on ‘prevailing practice’, it would not have been fatal to the company’s case that HMRC did not approve of these arrangements and that HMRC believed that PAYE should have operated. The correct question that should have been asked is whether, had the company taken a second opinion, it was inevitable that the advice would have been that PAYE should have been operated on the payments. In the light of the case law before 2015, such an outcome would have been far from inevitable.

In addition, the tribunal further dismissed the company’s arguments by pointing out that it had not in any event acted in accordance with prevailing practice because, as well as not applying PAYE, it had claimed a corporation tax deduction. However, even if the prevailing practice line of argument were relevant (which it was not), the only issue should have been was whether the P35s were in line with the prevailing practice and not whether the corporation tax returns (completely different documents which would be submitted at different times) also adhered to the industry norms.

Fourthly, the question of deliberate conduct seemed to focus on the fact that the directors knew that they were participating in an avoidance scheme and were consciously taking their part in the various steps. In all other tax cases, the courts and tribunals have insisted that this is not the key issue because the important point is whether the taxpayer knew that the return was incorrect when it was submitted. But in this case, the tribunal had already decoupled the question of the inaccuracy of the return from the conduct being impugned. With that novel interpretation of the statutory tests, HMRC's allegation of deliberate conduct was more likely to be met.

There was a further point that might be somewhat 'niche' but which stood out for me in the tribunal's decision. For entirely sensible reasons, a lot of focus was put on the adviser's letter to his clients before they chose to proceed with the arrangements. It is entirely right that the letter should have been carefully scrutinised to determine to what extent the directors had acted carelessly or deliberately when a key argument they were putting forward was that they had reasonably taken professional advice. As the tribunal also correctly pointed out, the best evidence as to what that advice constituted was the letter itself and not the witnesses' recollections some 14 years after the event.

What is surprising, however, is that the tax adviser was subjected to considerable questions whilst in the witness box as to how that letter should be interpreted. That is not a question for a witness but a matter that the barristers should have addressed when making their submissions to the tribunal.

What is even more surprising is that the tribunal itself seems to have asked (as it itself acknowledged in the decision) 'follow up questions of some length to try to get close to the meanings of the advice letter … as an attempt to ascertain the exact nature of the advice'. Particularly in a case being argued by experienced counsel on both sides, it is not normally appropriate for members of a tribunal to 'enter the arena' and start asking detailed questions of a witness. As to what actually happened here and whether that impacted upon the fairness of the proceedings is unclear. However, that is perhaps something that might emerge if the case proceeds on appeal.

What to do next

Although I hope this case goes to appeal and the novel approach to the statutory rules is carefully reviewed, the case does also provide a good reminder how the paperwork trail leading to (and following) any one-off arrangement could be closely examined in a tribunal many years down the line.

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