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The loan arrangers

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Keith Gordon discusses a recent First-tier Tribunal decision concerning schemes where contractors were paid in loans

What is the issue?

The loan charge remains controversial and the chancellor has announced an independent review, led by Sir Amyas Morse. Despite the loan charge, HMRC are seeking alternative ways to charge income tax in some cases.

What can I take away?

A large number of taxpayers have sought and obtained closure notices in respect of earlier years and appeals against these closure notices have been notified to the FTT. The decision in *Hoey v HMRC*, the first of these cases, has now been released.

What does it mean to me?

The tribunal concluded that ITEPA 2003 s 684(7A) gave a general discretion to HMRC to disapply the PAYE regulations – and that it was not open to the tribunal to consider whether HMRC exercised their discretion properly. This general discretion effectively circumvented the protections within the PAYE regulations themselves, which generally required HMRC to pursue employers and not employees for unpaid PAYE. However, the decision does not resolve many of the uncertainties that surround these cases.

The current controversy surrounding the 2019 loan charge concerns arrangements where earnings were received in the form of loans from employee benefit trusts (EBTs). Such arrangements were widely marketed as tax-efficient because, instead of attracting tax and National Insurance at the usual rates, the amounts advanced to the employee would escape tax altogether (although there might then be a subsequent and continuing liability on the benefit of not then paying a market rate of interest under the beneficial loan rules).

The Rangers case

HMRC had initially challenged such arrangements by arguing that the loans were ‘disguised remuneration’ and should be taxed as such when the EBTs made the loans. However, defeats at the tribunal stage in the *Rangers* litigation (because the tribunals upheld the principle that a loan is a loan and cannot be redefined as a payment of salary) led to a change of strategy. By the time that *Rangers* reached the Court of Session, HMRC newly argued that the initial appointment of the funds into the EBTs constituted the diversion of salary, on which PAYE and National Insurance should have been deducted. In other words, the EBTs should not have received funds gross. This new argument succeeded in the Court of Session and ultimately in the *Supreme Court (RFC 2012 Plc (in liquidation) (formerly The Rangers Football Club Plc) v Advocate General for Scotland* [2017] UKSC 45).

However, it gave rise to a potential difficulty so far as HMRC were concerned. The finding that the advance of the funds to the EBTs represented the event which triggered the obligation to deduct PAYE and National Insurance was widely regarded as meaning that any recovery action should ordinarily have been taken against the ‘employers’ (i.e. one of the UK entities in the contractual chain), rather than the employees. Yet because of the previous approach by HMRC (i.e. focusing on the advance of the loan by the EBTs, rather than the prior payment to them), HMRC had not pursued the employers and were now largely out of time to do so. On the other hand, HMRC had thousands of open enquiries into the individuals’ own tax returns. However, the PAYE regulations provide that employees are generally entitled to a credit for any PAYE that should have been deducted by their employers. HMRC thus needed to exercise their power to disapply the PAYE regulations and seek tax directly from the individual.

The loan charge

The loan charge imposed a charge on the employees by reference to the loans advanced (less any actual repayments before 6 April 2019) with a credit given for any tax already paid by the employees in respect of those loans. As the loan charge applies to individuals, it avoids the question of whether tax should primarily be sought from employers as PAYE. It also means that the charge applies even where HMRC were out of time to pursue the employers, or had not opened an enquiry or made discovery assessments in time.

Notwithstanding the potency of the loan charge, a large number of taxpayers have sought and obtained closure notices in respect of the earlier years and appeals against these closure notices have been notified to the First-tier Tribunal. The decision in the first of these cases has now been released (*Hoey v HMRC* [2019] UKFTT 489 (TC)).

The *Hoey* case actually concerns two discovery assessments, but this (for present purposes) is a minor point of distinction. It is a lead case for a number of similar cases.

Hoey: the facts of the case

Mr Hoey was an IT specialist who worked as a contractor on a series of medium-term contracts. Having experienced administrative difficulties with running his own personal service company, Mr Hoey engaged the services of an intermediary in order to reduce the paperwork. The intermediary introduced him to the EBT/loan arrangements as described above. As the tribunal found, Mr Hoey’s motivation was not to save tax but to avoid the complexities of running his own company. Indeed, most of the actual tax saving was swallowed up in fees and, as the judge confirmed, Mr Hoey did not really understand the underlying tax structure.

Following the *Rangers* decision, it was conceded that the arrangements were defective from a tax perspective; in other words, it was accepted that tax should have been deducted when the payments were made into the trust. Therefore, the principal line of defence adopted by Mr Hoey was the existence of the PAYE credit available to him under the PAYE regulations. In addition, Mr Hoey argued that the conditions for a discovery assessment were not met.

So far as the PAYE credit was concerned, HMRC responded by purporting to exercise a power under the Income Tax (Earnings and Pensions) Act 2003 s 684(7A)(b). That power permits HMRC to determine that an employer need not comply with the PAYE rules ‘in circumstances in which an officer of Revenue and Customs is satisfied that it is

unnecessary or not appropriate for the payer to do so'. The timing of this decision to apply s 684(7A) is not clear from the tribunal decision. However, based on my understanding from other cases, I strongly suspect that the decision was taken in late 2017 or in 2018, in other words several years *after* the discovery assessments to which they relate.

Furthermore, HMRC advanced a back-up argument, being that the arrangements were caught under the transfer of assets abroad legislation.

The questions before the tribunal

The case was heard by Judge Philip Gillett over seven days at the beginning of July 2019. The arguments focused on the following questions:

- Were the discovery assessments procedurally valid?
- Were HMRC entitled to transfer liability from the employers to Mr Hoey via s 684(7A)?
- Did the Transfer of Assets Abroad (TOAA) legislation apply to the arrangements?

The tribunal's decision

The judgment is relatively long and I do not propose to cover each aspect in detail.

In relation to the discovery assessments, Judge Gillett decided that a discovery had been made shortly before HMRC actually issued the relevant assessments to Mr Hoey. Although the two assessments under appeal had been made approximately a year apart, the judge considered the administrative processes established by HMRC to tackle these arrangements and that the calculation of each participant's potential under-assessment amounted to the actual discovery.

Furthermore, the tribunal considered that the disclosure by Mr Hoey on his tax return was not enough to alert the so-called 'hypothetical officer' to the potential under-assessment. Accordingly, HMRC were entitled to make the discovery assessments by virtue of s 29(5).

In relation to s 684(7A), the tribunal noted that the power circumvented the protections within the PAYE regulations themselves, which generally required HMRC to pursue employers and not employees for unpaid PAYE. Indeed, the regulations provide that the liability can be transferred to the employees only in limited circumstances and these are subject to the right of appeal. Nevertheless, the judge held that 'the wording of s 684(7A) seems to give a very wide discretion to HMRC and effectively renders Regulations 72 and 81 otiose'. He therefore held that Mr Hoey could not challenge HMRC's decision to transfer liability from the employers to him.

Although not necessary given the decisions on the other issues, the tribunal then considered HMRC's reserve argument as based on the TOAA legislation. It was conceded by Mr Hoey that his agreement to provide services to the end users amounted to a transfer of assets which led to income being received by a person abroad (being the offshore company through which Mr Hoey provided his services and which made the payments to the trusts).Of the contested matters, however, the tribunal concluded that the motive defence was not available to Mr Hoey. Although Mr Hoey did not enter into the arrangements to avoid tax, the tribunal considered that the arrangements were tax avoidance within the meaning of those words and that was sufficient to negate the motive defence. On the other hand, the tribunal considered that the income received by the persons abroad was nil. Thus, the TOAA rules were of little benefit to HMRC.

For completeness, the tribunal also considered that the rules were discriminatory under EU law (the rule which prevents restrictions on the free movement of capital anywhere in the world) but that such a breach was proportionate as it was to prevent tax avoidance.

Commentary

As I have noted, this was merely the first of several cases already before the tribunal. However, in my view, the decision does not resolve many of the uncertainties that surround these cases. As a result, I suspect that an appeal is inevitable. Furthermore, there is no guarantee that other First-tier Tribunal judges will agree with Judge Gillett on all of the issues arising.

First, in relation to the discovery assessments, Judge Gillett has (not improperly) focused on two decisions of the Court of Appeal (*Langham v Veltema* [2004] EWCA Civ 193 and *Sanderson* [2016] EWCA Civ 19). However, it is widely recognised that *Langham v Veltema* does not fully engage with the meaning of the 'hypothetical officer' test found in s 29(5); and provides that the hypothetical officer is not to be imputed with information to be gathered from his or her own research, but merely with the information as prescribed by s 29(6). As far as Sanderson is concerned, the difficulties with that case were explained by Judge Thomas Scott in *Hicks* [2018] UKFTT 22 when he said:

> 'I do not find the Court of Appeal's analysis of these issues in Sanderson, which is of course binding on me, entirely easy to understand or apply in practice… The difficulty which that produces in my judgment is that while there is guidance as to what the necessary level of awareness is not there appears to be no clear guidance as to what it is.'

HMRC's appeal to the Upper Tribunal in *Hicks* is due to be heard later this month and therefore it is hoped that some further clarity will emerge.

So far as s 684(7A) is concerned, I find the tribunal's decision in *Hoey* most surprising. Although the judge expressly refers to the wording of the sub-section, there does not appear to be the recognition that there is nothing in the legislation that suggests that the power can be used retrospectively, as appears to be the case here.

In my respectful opinion, there is a vast difference between (on the one hand) deciding that an employer need not operate PAYE in respect of a particular employee and (on the other) forgiving previous non-compliance. Indeed, the judge referred to HMRC's own PAYE guidance, which expressly endorses the view that the only way HMRC can transfer a historical liability from the employer to the employee is under the PAYE regulations themselves. Instead, he seems to have accepted at face value the evidence of HMRC's witness that the guidance was 'wrong'. What is even more striking is the fact that the HMRC witness was seemingly not a PAYE expert, given that he had not previously seen the guidance.

What to do next

The decision will be a disappointment to those who have participated in similar arrangements and it shows how the tribunal might deal with other cases. However, it is likely that the decision will be subject to an appeal (and, indeed, as already noted, the decision is not even binding on other cases). Therefore, my advice is to await further developments.
