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Dear Sirs

Comments of the Revenue Law Committee on the Draft Legislation for Finance Bill 2011 in relation to Disguised Remuneration

The City of London Law Society (ñCLLSò) represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the draft legislation dealing with disguised remuneration has been prepared by the CLLS Revenue Law Committee.

We are pleased to have the opportunity to comment on the draft which will be included in Finance Bill 2011.

Overall comments

We are aware of the planning arrangements, mainly involving loans from trusts which may never be repaid, in response to which the disguised remuneration legislation has been drafted, and we agree that they are unacceptable avoidance which it is appropriate to counter by way of legislation.

However, our view is that the draft legislation is ill targeted and catches an extremely large number of arrangements which in our view are entirely legitimate, and which it is no part of the expressed policy behind the rules to affect. The notes accompanying the draft legislation indicate an intention to target a relatively narrow range of unacceptable planning, but the legislation itself casts its net much wider. Furthermore, the legislation, apparently by design, imposes a particularly penal regime on the arrangements to which it applies, which in our view makes it all the more critical that it be accurately targeted.

We understand that a policy decision has been taken that attacking the offensive arrangements using a targeted anti-avoidance rule ("TAAR") would not be appropriate given the risk that variations of the existing planning might emerge rendering the rule ineffective. However, given the widespread problems with the draft legislation, which is of course in part expressed to be in force from the date of announcement, a far better approach would have been to announce a narrow TAAR taking immediate effect on a temporary basis while broader provisions were put out to consultation.

Even if this approach was adopted, we do not believe that the broader provisions should take the form of those proposed. We believe that the right approach to drafting this regime is to identify the mischiefs and target them, not to draft to catch everything and then apply exclusions. Particularly where the regime is designed to be penal we consider it critical to ensure that no unintended targets are caught within it.

If this approach is impossible and it is decided to continue with legislation in something of the shape of the draft, we fear that the defects in the draft legislation are so profound that it may be impossible to remedy them properly in time for the 2011 Finance Bill process. Our recommendation would therefore be that the most appropriate course would be to replace the draft legislation with a TAAR in the short term (which need not include a tax avoidance motive test if it was sufficiently well-drawn), with a view to enacting the full regime, after appropriate consultation and adjustment, as part of Finance Bill 2012. This approach would be similar to that adopted in relation to the anti-avoidance measures recently introduced in relation to disguised interest, where it appeared to work well.

The introduction of this draft legislation, in part with immediate effect, has created immense uncertainty and confusion for business at a very sensitive time economically. The fact that the scope of the draft legislation so greatly exceeds its stated purpose has made it impossible for advisers even to be confident as to the policy objectives behind it.

Back in June, to widespread acclaim, the Government stated in its consultation document: "Tax Policy Making ï A New Approach" that it wanted to "restore the tax system's reputation for stability", and that it was "committed to providing clarity and certainty on the future direction of tax policy". On any measure this draft legislation has achieved the opposite of these objectives, with consequent significant damage to the credibility of the new policy making process. The fact that it was introduced as a revenue protection measure should not be seen as a legitimate excuse for creating uncertainty on this scale.

The remainder of this response will first address some points of concern of application to the regime as a whole, and will then identify a series of innocent circumstances which in our view are either clearly, or highly arguably, within the draft rules. We believe that once the legislation is in its final form, it must be clear from the law ï without the need to rely on guidance ï that these circumstances are outside the scope of the rules. As discussed above, our preference would be for this to be achieved by approaching the drafting differently and seeking to define only what should be caught, rather than having very broad provisions which are then reduced by exclusion. However, our points may be applied equally validly either way.

We have not at this stage produced amended drafting due to the extent of the issues we have at a policy level, but would be happy to assist with this process once the policy is better formulated.

Particular points of concern

Non-repayment of tax when benefit not received

The key feature of the legislation is to accelerate the point of charge to the point where an asset is made available to the benefit of an employee rather than when a legal right to the asset arises. We agree that a charge on this basis is necessary to counter structures where loans are advanced which are in practice unlikely to be repaid, with a view to providing employees with the benefit of cash without triggering a taxable event.

However, the legislation contains no provision for a refund of the tax paid in the event that the loan in question is in fact repaid, or, in relation to the earmarking rules, if after being earmarked it becomes clear that a sum will not be payable to a particular individual. We understand that this was a conscious policy decision designed to make the regime penal in nature.

We would urge a rethink of policy on this point. As a matter of principle this seems profoundly unfair. Clearly it would be necessary on reversing any employment tax charge for any deduction claimed by the employer in respect of the provision of the benefit to be reversed as well, but this appears to us to be a relatively simple adjustment which would lead to a greatly improved overall result. The refund of tax should also apply to any charge under s.222 ITEPA associated with the provision of the benefit (or a charge on a cash bonus paid to fund the PAYE and NIC): as we note below, such a charge will almost inevitably arise in the cases of innocent loans.

Here we would emphasise again the ill targeted nature of the legislation. The importance of this concern will reduce greatly if the rules are targeted narrowly on obviously offensive schemes, but as drawn a large number of entirely innocent arrangements would be drawn into these penal rules. This cannot be appropriate.

We would also note the extremely high effective rates which these provisions inevitably produce in an innocent situation. Where an employee is made a loan for legitimate reasons, he generally needs a certain amount of cash in his hands (since the loan will be being advanced to fund a specific cost such as perhaps the cost of a season ticket or an overseas tax bill in respect of which a claim for treaty relief is being processed). Under the new rules this will give rise not just to a PAYE liability on the amount of the loan, but also, inevitably, to a charge under s.222 ITEPA or a need for a taxable bonus purely to fund the tax (since by definition as the employee needs the full cash amount he will not be in a position to fund the PAYE himself). In practice the bonus route is far likelier, as otherwise the tax arising under s.222 will reduce the cash amount needing to be retained by the employee.

As a result, assuming that a cash bonus is paid to fund the PAYE, in order to advance a loan of £100 to an employee, a company will need to account for total tax of £25, £66.67 or £100 (ignoring NIC) depending on the applicable rate of income tax which the employee pays.

Additionally, any benefit in kind charge in respect of sub-market rate interest is not disapplied even though the rules are taxing the loan as an outright payment at the time of advance. This too seems logically inconsistent and unduly penal.

So, as drawn, the making of a loan to an employee for entirely legitimate purposes, where the loan is fully intended to be and in fact is repaid, will trigger a tax charge on a grossed up basis which is non-refundable even though the loan is repaid and so it transpires that the employee has in fact received no benefit. This is arbitrary, unfair, and must be corrected.

The problem here is that where a loan is advanced in the targeted avoidance circumstances, it is quite reasonably treated as being equivalent to a gross bonus of the amount of the advance. An employer could then retain some of the advanced amounted, with the employee effectively using part of the loan to fund the PAYE. However where the loan is advanced to meet a specific cost in the legitimate circumstance, the rules, in practice, have to treat the amount advanced as equivalent to a net bonus of the amount of the loan. The rules therefore impose significantly greater tax costs on employers in innocent situations than in avoidance cases.
Furthermore, we are aware that in various discussions that have taken place between HMRC representatives and professional bodies, HMRC accepted that they were finding it hard to carve out loans which they admitted were inoffensive as a policy matter, without achieving the foremost objective of making the legislation avoider proof. If it is acknowledged that some legitimate arrangements will inevitably be caught, then the case for a special penal regime is surely irreparably damaged.

Employment related securities

As will be apparent from our examples below, a large number of the areas where the legislation applies inappropriately are connected with the acquisition, holding and disposal of employment related securities.

Our view is that any amounts received through the holding of employment related securities should be outside the scope of the new rules on the basis that there is a comprehensive code for the taxation of such returns in Chapter 7 of the Income Tax (Employment and Pensions) Act 2003.

If HMRC is, or becomes, aware of schemes which disguise remuneration as returns from employment related securities in order to secure tax advantages, these schemes should be addressed by a TAAR within Part 7 ITEPA.

We are aware that in other discussions HMRC have accepted that conventional acquisitions of securities for full value by employees should not be within the scope of the rules, but have expressed resistance to a full carve out for employment related securities on the basis that they are concerned in particular about some geared growth arrangements.

If this is the case, this is unacceptable policy creep and a very serious deviation from the Government's tax policy making process. Geared growth arrangements are no part of the expressed policy rationale behind this legislation, and of course the Government has postponed a consultation into this very area. The taxation of geared growth securities is a complex area which fully merits a proper review. However, attempting to address geared growth via this legislation is both disingenuous and contrary to the new policy making framework.

We have also heard suggestions that such a carve out might be structured by excluding returns from shares in respect of which elections under s.431 ITEPA have been made. We do not think such a carve out would be adequate, mainly because it is unclear that it would be effective in relation to unrestricted securities in relation to which the making of an election would be meaningless. Additionally, many small businessmen starting up their own companies with pure equity funding are likely to be unaware of the possibility of making such elections (and would clearly have paid market value for their shares such that charges would not arise under ITEPA even absent such an election).

We would reiterate: the taxation of returns from employment related securities is an area with a highly evolved and largely effective tax regime. The avoidance which has motivated the disguised remuneration rules is nothing to do with employment related securities. A full carve out for returns from such securities should be included.

The Remuneration Code, and other legitimately deferred remuneration

A particularly unfortunate feature of the draft legislation is that as a policy matter it appears to contradict the Remuneration Code being imposed on the financial sector by the Financial Services Authority in response to the financial crisis. This Code provides that in many cases remuneration must be deferred, and made subject to contingencies. The draft legislation would appear to tax such remuneration on initial allocation, and, as noted above, does not provide for any repayment of that tax if the remuneration is not eventually paid.

Remuneration subject to the Remuneration Code must in our view clearly be excluded from the new rules. However, we believe that this exclusion should go further so that all legitimately deferred remuneration is excluded, whether or not the relevant employers are within the scope of the Code. Deferring performance related remuneration until such point as the performance can be properly measured is surely something to be encouraged as a general matter, even in unregulated industries not subject to the Code. It seems perverse to design a tax system which will render remuneration practices which are encouraged (and, where the regulatory framework permits, required) by the Government prohibitively costly.

A similar grossing up problem arises in relation to earmarking to that described above in the case of loans. Again the problem is caused by the likely impracticality of deducting PAYE from an employee's basic salary at the point when the obligation to pay arises.

Earmarking must occur at the point when an employee is notified of a bonus, even on a contingent basis. However in practice it will not be commercially acceptable to deduct PAYE on the bonus from his pay at this point, since he will have received no actual benefit (it may not even be possible if, as will often be the case, the bonus is large relative to his monthly salary). So, as with the loan advance example, inevitably the employer will need to pay a bonus to enable the employee to fund the PAYE and prevent a charge under s.222 ITEPA arising. This bonus will of course itself be taxable.

So, if a bonus of £100 is earmarked, the employer will end up having to account for PAYE of £25, £66.67 or £100 on the combination of the earmarked amount and the bonus payment made to fund the PAYE (NIC is ignored in this example for simplicity, but would make the problem worse).

Eventually, if and when the bonus of £100 is paid, the employee will be expecting to receive it net of tax and the employer will presumably pay him £80, £60 or £50 depending on the applicable rate. No further tax is actually due from the employer at this point due to the no double counting rule in the new provisions. However, the employer has actually paid rather more tax than the amount that should be payable. In the case of the top rate taxpayer, in order to pay a net bonus of £50 the employer has had to pay PAYE of £100 ï double what the result should be if the system is working properly.

In a similar way to the above example relating to loans, the problem comes because the inability to collect PAYE from the employee at the time the charge arises effectively means the new rules treat the amount earmarked as if it was the net amount of the bonus eventually payable - when in fact it is the gross amount. The effective rate of tax on the bonus is therefore increased enormously.

Provisions enabling the refund of tax paid by reference to the amount eventually received by the employee would help, but they would be reasonably complex and would also need to enable the unravelling of any cash bonuses paid to fund the PAYE obligation arising on earmarking. Far better would be to define properly the offensive arrangements so innocent cases are excluded entirely.

We cannot see a solution to the problem of separating the enormous range of entirely legitimate deferred remuneration arrangements (both within and without the Remuneration Code) from avoidance structures that does not involve a tax avoidance motive test. However this separation must be achieved, as otherwise the new rules will operate to subject deferred remuneration to a prohibitive tax cost, which would be an extraordinary result given the general consensus that deferring bonuses until such point as performance can be accurately measured is to be encouraged.

The definition of "relevant third person"

Many of the worst practical problems created by the legislation could be mitigated with an improvement to the definition of "relevant third person" in s.554A(7)(1)(d). Employers are excluded from the definition, but members of employers' groups are not. Many legitimate arrangements involve the making of a loan by one group company to employees of another.

We appreciate that in amending this definition, provisions may be necessary to address the risk of entities that are in reality third parties being artificially grouped in order to take advantage of a wider exception from the "relevant third person" definition. However this could be easily achieved, and approaching the issue in this way rather than excluding employers alone would reduce some of the more anomalous results of the draft rules.

Example cases to which the rules appear to apply, but in our view should not (by no means an exhaustive list)

- car leasing arrangements for employees

- loans to employees to fund overseas tax liabilities which will be reclaimed via double tax treaties

- season ticket loans to employees

- cashless share option exercise mechanisms

- maternity leave loans (the many businesses which pay maternity pay in addition to the statutory minimum will generally structure that pay as a loan which is repayable only if the employee does not return to work and/or remain in employment for a set period, and which is otherwise waived)

- subscriptions of shares by employees (the carve out in s.554O applies only to transfers of assets, which in our view would not include a subscription)

- dividends or interest paid on shares or loan notes held by employees working for a company other than the issuer of the securities

- sale proceeds of shares (especially in the private equity context where an exit within a finite timescale is planned from the outset, so it is hard to be confident that the exit is not part of the arrangements under which the shares are acquired given the broad definitions involved)

- earnout payments on company sales (particularly where they are subject to continued employment), on the assumption that at some point prior to payment the buyer earmarks the necessary funds

- phantom share option schemes

- some carried interest arrangements, especially where new carry partners join after the fund in question is first set up

Conclusion: key points

This draft legislation is not fit for purpose and should be withdrawn and re-examined in totality. Its introduction has caused massive uncertainty in the business community and it is already damaging the economy at this delicate time. It has also greatly damaged trust in the Government's promised new approach to tax policy making.

The fear that targeted anti-avoidance rules may be sidestepped is no justification for introducing a penal regime which is acknowledged as likely to catch some innocent circumstances.

The legislation is particularly damaging because it impacts on such a wide range of businesses. Concerns are of course particularly acute in the private equity industry due to the potential impact on managers' equity stakes. However, great numbers of businesses of all shapes and sizes employ all their staff through group service companies for ease of administration (not least in relation to PAYE). Under these proposals, if any of these businesses lends one of their employees any amount for any purpose, penal tax charges will arise. (The service companies will not have the funds to advance the loans themselves, so will need to be funded by other group companies. This intra-group advance of funds will trigger the charge, even if the actual loan to the employee comes from the service company employer.)

Since we recognise the urgency of stopping the avoidance which has led to the publication of this legislation, we suggest a narrowly targeted anti-avoidance rule be introduced with immediate effect, aimed precisely at the loan- and trust-based avoidance structures in question. Consultation can then continue as to the best form of a broader regime.

In the longer term a targeted anti-avoidance rule with a tax avoidance motive test and a clearance must be the best solution in areas such as this where avoidance may be structured in difficult ways and so is difficult to define without collateral damage. We recognise that there are resourcing implications to this. However, we submit that these resources must be found if Britain is to be seen as "open for business" as the Government apparently desires.

Yours faithfully

Bradley Phillips
Chair
City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

Individuals and firms represented on this committee are as follows.

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