

## The 5 April 2019 loan charge – Part I

**(Lecture P1083 – 6.58 minutes)**

### *The background*

To understand this fully, we first need a short history lesson.

Historically, a very common remuneration planning arrangement for businesses was to reward their employees via a third-party vehicle such as an Employee Benefit Trust ('EBT'). EBT schemes have been around since the 1980s. So rather than paying employees wholly in the form of traditional wages (liable to tax and NIC under PAYE), firms would make contributions to an EBT.

Typically, these trusts were housed offshore to remove them from additional UK tax obligations. Employer Funded Retirement Benefit Schemes ('EFRBS') – essentially unapproved pension schemes - were used for a similar purpose.

In EBT arrangement, the company would receive a CT deduction in the period of the contribution. The EBT would subsequently give the UK employee access to the contributed funds by way of a loan. Such loans were invariably interest-free with no specific repayment terms.

Contractor loan arrangements are a more recent phenomenon but work in the same way.

In a typical arrangement, a contractor carries out his work on behalf of a client via an umbrella company that engages a large number of like-minded contractors. The umbrella company handles the billing and is paid by the end client.

The contractor is then paid a small salary (usually at or around the level of the personal allowance and just above the minimum wage) but his remuneration is topped-up by way of a loan that normally comes from an offshore vehicle established for this purpose. The loans were interest-free with no repayment terms discussed.

Loans – assuming the expectation of eventual repayment – are not earnings. These loans were employment-related so the employee had a taxable benefit-in-kind calculated by reference to the HMRC official interest rate giving an annual UK tax liability on the use of the money at somewhere around 1% or 2% of the amounts advanced. [Some loan schemes charged interest at the ORI to avoid a P11D benefit altogether with the interest rolled-up and added to the capital of the loan.] This was far more palatable than the 40% / 45% / 50% (plus NIC) which would have been due if the money had been paid to the employee as boring-old wages.

It was inevitable that the Government would react. And they did.

### *Strike 1*

The Government's first strike in the ensuing battle came in the case of *MacDonald (HMIT) v Dextra Accessories Ltd & Others* [2005] ('Dextra'), where the House of Lords unanimously agreed with HMRC that the employer company could not receive a CT deduction until the contributions were used to pay taxable earnings to the employee. Loans didn't count as taxable earnings, so the effect of Dextra was to deny the CT deduction.

Dextra subsequently spawned s.1288 CTA 2009 et seq which now creates a symmetry between the employer deduction and the employee earnings charge. But Dextra and CTA 2009 only dealt with the mismatch between the CT deduction and the income tax charge – it did not address the avoidance of tax and NIC by the employees (and the knock-on avoidance of secondary NICs by the employer). This was addressed in 2010.

### *Strike 2*

The second punch thrown by the Government came in the shape of the "Disguised Remuneration" rules introduced with effect from 9 December 2010, enacted in Finance Act 2011 and now sitting on the statute books as Part 7A ITEPA 2003 under the banner "Employment income provided through third parties". The cornerstone of these rules is to treat certain payments from third parties as being subject to income tax and Class 1 NIC.

The gateway to a Disguised Remuneration charge is:

- An arrangement with the employer to provide rewards to an employee; followed by
- The taking by a third party of a "relevant step" in pursuance of that arrangement.

A "relevant step" includes the making of a loan, the transfer of an asset, the use of an asset, or the earmarking of money or assets (however informally) for an employee with a view to a later relevant step being taken. The main target was third party loans.

The amount charged to income tax is the value of that "relevant step".

So, if an employer contributes to an EBT and on or after 9 December 2010 that EBT then lends £100,000 to an employee, we have all the ingredients for a Disguised Remuneration charge being:

- An arrangement to provide rewards to an employee;
- A relevant third party (in the form of an EBT); and
- A relevant step (being the making by the EBT of the loan).

The £100,000 is accordingly treated as earnings with tax and NIC deductible under PAYE.

Relevant steps taken before the announcement of the new rules in December 2010 were not caught by the Disguised Remuneration provisions in Part 7A. This meant that existing schemes with loans outstanding found themselves in a strange state of inertia.

Technically existing loans made to employees remained on their books but there was no expectation on the part of the EBT that the loans would ever be repaid (and indeed many employees had no means of repaying the debts having spent the money). These pre-2010 EBTs duly stopped making loans and hibernated.

In reaction to this set-back, a new generation of more creative arrangements has sprung-up since December 2010. These schemes have attempted to find holes in Part 7A and have manipulated those weak spots to reach the same end-point as before – ie, to provide rewards to employees via debt arrangements with third parties in such a way as to fall outside the Disguised Remuneration provisions.

All of which leads us to....

### *Strike 3*

The latest (and seemingly knockout) blow will be coming shortly in the shape of the April 2019 Loan Charge enacted in Schedule 11 Finance Act (No. 2) 2017 as “Employment income provided through third parties: loans etc outstanding on 5 April 2019”. Catchy.

In short, this new charge will revisit both pre-2010 schemes and any new ones which have sprouted up since December 2010 and will hit them with a thumping-great income tax charge.

Schedule 11 does this by creating a new ‘relevant step’ for the purposes of Part 7A ITEPA 2003 which brings pre-December 2010 loan arrangements and post-2010 debt schemes within the Disguised Remuneration provisions. The 2019 Loan Charge will then be levied on third party loans that remain outstanding at 5 April 2019.

If this smacks of retrospective taxation, then Strike 3 is even more brutal as it backdates the new charge by 20 years to apply to loans made on or after 6 April 1999 (more than 11 years before the original announcement trumpeting disguised remuneration). So old loans that were never originally within Part 7A ITEPA 2003 will now be dragged in.

Loans made before 6 April 1999 will not be caught. Neither will loans made to non-employees, loans not involving a third party or loans that have been fully repaid by 5 April 2019. One option here is therefore for the employee to repay the loan (unpalatable as that is).

Repayments must be “in money” so the employee cannot surrender an asset in satisfaction of the debt (he will instead be required to sell the asset and use the resulting cash proceeds). The loan charge is avoided if the capital of the loan is repaid (any outstanding interest, even if capitalised, can remain outstanding).

The amount charged to income tax and Class 1 NIC is the value of that “relevant step” being the loan outstanding at midnight on 5 April 2019. The taxpayer will therefore be treated as having employment income equal to the amount of their third party loans which have not been repaid by 5 April 2019.

The tax charge is triggered at the point of the relevant step. In most cases this will be 5 April 2019 thereby bringing the tax liability into the tax year 2018/19. There is no provision to trace the payment back to the year(s) to which the loan relates, so dumping the tax charge wholly into one tax year will in many instances create an eye-watering charge of 60.8% of the loan outstanding.

Taxpayers who do not pay income tax at the additional 45% rate will obviously have a lower charge but might in turn suffer knock-on charges in the form of a withdrawal of personal allowances in 2018/19 or the imposition of a high-income child benefit charge. The potential windfall for the government here is massive and could generate as much as £2 billion (assuming of course they can collect it all which is another matter).

The April 2019 trigger date can be deferred if the loan outstanding is an 'approved fixed term loan' in which cases a charge will only arise on amounts which remain unpaid at the approved repayment date. An 'approved fixed term loan' is one which was made on commercial terms and where capital repayments have been made to the lender and at intervals not exceeding 53 weeks. EBT and contractor loans are unlikely to fall into this category.

Where a third party takes a loan charge relevant step and the loan is also an employment-related loan, the new Schedule 11 provisions prevent that loan from being treated as a taxable cheap loan for the purposes of the beneficial loan legislation. This means that if an employee has a loan charge in April 2019, no further benefit charge will arise after 5 April 2019 in relation to the beneficial loan (even if it remains outstanding). However, there are no provisions to credit any amounts previously taxed under the beneficial loan rules against the 2019 loan charge.

*Contributed by Steve Sanders*