A tale of two avoidance schemes

George Turner analyses the different approaches HMRC has taken to sideways loss relief schemes and disguised remuneration arrangements.

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The tax avoidance industry has been through a remarkable transformation over the past decade. Ten years ago, there were only two tax avoidance schemes that were sold to individuals in any volume: sideways loss relief schemes and disguised remuneration schemes. According to HMRC figures, in the 2013-2014 tax year 35% of all users of tax avoidance schemes – 8,500 people – were members of sideways loss relief schemes. Today that figure is zero.

Over the same period, disguised remuneration has flourished. There were 13,200 people involved in disguised remuneration in 2013-14, but this has risen to 28,000 in 2019-20, the latest year when figures are available.

Why is it that HMRC has been so comprehensively successful at combating one form of tax avoidance, while demonstrably failing to deal with another?

Respectable end of the avoidance market

In an appearance before the House of Commons Public Accounts Committee last year, Jim Harra, HMRC chief executive, offered one explanation: 'The situation with the promotion of tax avoidance is over recent years, we feel we've been very successful at driving the respectable end of the tax profession out of offering tax avoidance.' Clearly, we have come a long way since David Hartnett described sideways loss relief schemes as 'schemes for scumbags'.

Key points

- In 2013, there were in effect two marketed tax schemes – sideways loss relief and disguised remuneration.
- Several court decisions ruled that sideways loss relief schemes were ineffective from a tax law perspective.
- There have been criminal prosecutions of people who operated these schemes.
- HMRC has won two cases – *Rangers* and *Aberdeen Asset Management* – on disguised remuneration and that was on the PAYE argument.
- The loan charge has helped promoters with the argument that nothing was wrong until HMRC changed the law retrospectively.

In particular, HMRC points to the code of practice on taxation for banks (large banks were frequently involved in providing the finance for sideways loss relief schemes), and the tightening of professional conduct rules for accountants and tax advisers in 2017, which in effect made it a disciplinary offence to sell a mass marketed tax avoidance scheme.

The implication is that more senior professionals subject to professional regulation were successfully persuaded to get out of selling the schemes to their clients.

Although it is the case that sideways loss relief schemes were mainly targeted at high net worth individuals – the kind of people that employ professional accountants and lawyers and are clients of private banks – sideways loss relief schemes are not a form of tax avoidance defined by the involvement of professional advisers.

It is well known that many senior lawyers signed off on disguised remuneration schemes, senior accountants operated and sold the schemes and former HMRC inspectors regularly pop up as being involved with disguised remuneration. In fact, it was recently confirmed that an accountant that acts for the royal family is one of the more significant players in the field of disguised remuneration.

If it really is the case that improvements in professional standards have driven out the respectable end of the avoidance market, why have allegedly respectable people continued to market disguised remuneration schemes?

The simple answer is that codes of practice and professional ethics will only ever take us so far. That is not to say that improving professional standards is unimportant. It is, but sadly there will always be morally vacuous people in every profession who will seek to make a profit from taking advantage of others.

In the end, the most effective way of stopping any form of tax avoidance is to establish that a scheme is unlawful with regard to tax law.

As Lord Templeman put it many years ago: 'Every tax avoidance scheme involves a trick and a pretence. It is the task of the Revenue to unravel the trick and the duty of the court to ignore the pretence.'

It is also important to ensure that dishonest behaviour is challenged, if necessary by way of the criminal prosecution of those that seek to promote dishonest tax avoidance schemes. As it was recently put by Lady Justice Simler and Mrs Justice Whipple in *Ashbolt and Arundell v HMRC and Leeds Crown Court* [2020] STC 1813 (tinyurl.com/52jkf99v) 'tax avoidance moves from lawful conduct to criminal conduct when it involves the deliberate and dishonest submission of false documents to HMRC with the intent of gain by the taxpayer in question and loss to the public revenue'.

When we analyse the performance of HMRC in both the civil and criminal courts, it is here where we see a real difference in performance with regard to different forms of tax avoidance.

Sideways illusion

Sideways loss relief schemes worked in the following way. Investors, who were always high earners with large income tax liabilities, entered into a partnership that was formed on the pretence of carrying out some form of trade.

To encourage potential clients into the arrangements, often, scheme designers based them around well-known tax reliefs, marketing the scheme as a government-supported initiative. Film schemes such as Eclipse and Ingenious are perhaps the most well-known examples, but there were also schemes that invested in vaccine research or reforestation and green energy. However, almost any investment could be used to claim sideways loss relief, such as the well-known Working Wheels scheme based on the used car industry, and some lesser known schemes investing in computer software.

The expenditure incurred in the trade would result in losses which were used to reduce the income tax liabilities of the partners under the sideways loss relief rules. The trick was that these losses were inflated by circular financing arrangements which meant that the tax write-off ended up being multiples higher than the amounts of real cash put in by clients of the scheme.

The effect of this inflation also meant that the majority of capital raised by the partnerships would never actually be spent on the trade itself. For example, in *Vaccine Research Limited Partnership Scheme v CRC* [2015] STC 179, the partnership claimed to have spent £114m on developing various vaccines, when in fact only £14m had been spent on research and development with the balance being paid in fees to the scheme operators and the banks that had funded the contributions of partners in the first place.

HMRC disallowed the claims for tax relief for partners of sideways loss relief schemes, arguing that to qualify, expenditures had to be incurred for the purposes of a trade, and the partnerships needed to operate on a commercial basis.

Even though the schemes contained some commercial element which meant that it was theoretically possible for them to earn a profit, the inflation of losses made the prospect of any profit actually being made in the long term wholly unrealistic, undermining any idea that the partnerships were a commercial enterprise.

As Judge Colin Bishop put it in his First-tier Tribunal decision in the Icebreaker case *Acornwood and others* (TC3545): 'A 14-handicap golfer may set out on the first tee with the aim and hope of going round the course in par; but he could have no reasonable expectation of doing so.'

The courts were generally supportive of HMRC's arguments, and there followed a long line of cases where various sideways loss relief schemes were defeated. This includes *TowerM Cashback*, *Working Wheels*, *Eclipse*, *Ingenious* and *Vaccine Research*.

In some cases, HMRC started criminal proceedings.

According to HMRC, since April 2016, 22 people have been convicted of 'offences relating to arrangements that have been promoted and marketed as tax avoidance'. A review of HMRC press releases reveals that at least 20 of these individuals were involved in sideways loss relief schemes.

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In these cases there was usually some aggravating factor which attracted the attention of HMRC's criminal investigators. For example, in the case of *R v Michael Richards and others*, it was found that a sizeable chunk of the money that was supposed to have been invested in reforestation projects was being siphoned off into secret Swiss bank accounts for the personal benefit of the scheme operators.

However, it is also remarkable that in at least some cases, the core elements of the offences prosecuted by the crown were the very basis on which sideways loss relief schemes operated.

In his sentencing remarks following the conviction of four individuals behind the Little Wing film scheme Judge Drew described the 'cheat' as: 'Submitting tax returns which contained false statements about the LLP's allowable losses. They were false because the jury found as a fact either that the expenditure was not wholly and exclusively for the purposes of the LLP's trade, or the trade was not carried out on a commercial basis.'

He may not have been aware of it at the time, but Judge Drew, in summarising the guilty act of a serious criminal offence, was in effect describing how all sideways loss relief tax avoidance operated. Something which must have at least given some promoters pause for thought.

Legal confusion

HMRC has not had the same success when it comes to disguised remuneration schemes.

Many of these arrangements involve the creation of an offshore employee benefits trust. A company employing an employee or contractor would place funds into the trust, which would then be loaned to the employee. The trust might also provide some other benefit, such as a gift of shares in a company controlling a bank account full of cash.

The scheme promoters argued that because the trust was independent of the company and that the loan was in theory repayable, then it should not be counted as income for tax purposes. The reality however, was that the trust always paid the loan and never asked for the money back. Both employers and employees regarded the money as income for the employee to keep.

“Early attempts by HMRC to deny the benefit of schemes to taxpayers were met with opposition from the judiciary.”

Early attempts by HMRC to deny the benefit of schemes to taxpayers were met with opposition from the judiciary. In two cases that went before the Special Commissioners in 2000s, *Dextra Accessories* (SpC 331) and *Sempra Metals* (SpC 698), the judges found that loans granted by the employee benefit trust were not taxable income. In both cases the government decided not to appeal the point on income tax.

In 2013 the Court of Session accepted HMRC’s argument that *Aberdeen Asset Management v CRC* [2014] STC 438 should have withheld income tax under PAYE for payments made to employees made through an employee benefit trust. HMRC won on the same argument again at the Court of Session in *Murray Group Holdings v CRC* [2016] STC 468, defeating the Rangers employee benefits trust scheme.

In that case the judges was scathing of the rulings of the tax tribunals, which until then had found in favour of Rangers, saying:

> ‘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… 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. That, it seems to us, is what happened before the First-tier and Upper Tribunals in this case.’

The Court of Session decision was later confirmed by the Supreme Court (*RFC 2012 plc (formerly known Rangers Football Club plc) v Advocate General for Scotland* [2017] STC 1556). Both the Court of Session and the Supreme Court found that *Sempra* and *Dextra* had been wrongly decided.

However, although the *Rangers* case established beyond any doubt that the payments made to an offshore trust in relation to employment should be considered earnings and taxed as such, campaigners rightly point out that the case does not establish that employees in disguised remuneration schemes should be liable to pay the tax themselves.

This was recognised by Jim Harra himself, in an email unearthed through a freedom of information request where he expresses frustration that he has been unable to obtain a legal analysis to back HMRC’s position that individuals are taxable on earnings received via a disguised remuneration scheme.

One key difference between the findings of the civil courts in cases involving sideways loss relief and disguised remuneration, is that by removing the benefit of tax relief from the partners, the courts have taken away all the incentive for investors to participate in these schemes.

With disguised remuneration, without a judgment that establishes that scheme users are liable for any tax bill, the incentive for an employee to take part in the scheme remains. Employees will care little if a scheme means that they reduce their tax bills, whilst their employer runs the risk of being hit with a tax bill in the future.

This is in fact how some disguised remuneration schemes have played out, with organisations like the BBC agreeing to pay off the tax liabilities of freelancers engaged through tax avoidance schemes.

Limitations of legislative fixes

The most significant intervention the government has made against disguised remuneration has been the loan charge, a piece of legislation that attempts to ensure that people historically involved in disguised remuneration schemes are subject to taxation without the need to raise an enquiry into the scheme or a taxpayer’s returns.

However, in the absence of any decision of a court establishing that the users of loan based remuneration schemes had any tax liability at all, the use of legislation to enforce HMRC's view of the existence of that liability has proved highly problematic.

Inevitably, it has been interpreted by many people as demonstrating that disguised remuneration was at the time a lawful means of reducing a tax on the part of an individual taxpayer, which a defeated HMRC has been forced to attack with retrospective legislation, something which goes against every principle of justice in this country.

The perception that the loan charge is an unjust act of a vengeful administration has pushed scheme users into the arms of promoters of loan charge avoidance schemes.

As a policy designed to draw a line under disguised remuneration the loan charge has been a complete failure. Participation in disguised remuneration schemes increased substantially between the announcement of the loan charge in 2016, and its implementation in 2019.

Learning lessons

By looking at the history of litigation in both the civil and criminal courts, the answer to the question, why has HMRC been much better at tackling sideways loss relief schemes than disguised remuneration, is obvious.

Through careful, painstaking litigation HMRC have managed to establish the principle that sideways loss relief schemes are not only ineffective in tax law, rendering the whole enterprise pointless for scheme users, but that the promotion and operation of these schemes could be regarded a cheat on the revenue, ending with a period of incarceration at her Majesty's pleasure.

It is little wonder that the use and promotion of these schemes has stopped entirely.

Until now at least, HMRC have not been able to establish the same with regards to disguised remuneration.

As recently confirmed by the financial secretary to the Treasury, the number of people that have been the subject of a successful criminal prosecution is precisely zero. Despite a barrage of legislative remedies, the practice continues to operate.

This may soon be about to change. HMRC recently disclosed for the first time that it currently has 17 people under active criminal investigation for 'offences relating to arrangements promoted as disguised remuneration tax avoidance schemes'.

The only investigation where details have emerged publicly, Operation Skeet, is connected with alleged attempts by Paul Baxendale Walker's firm (or its successor) to rebrand loans so that they fell outside the scope of income tax and the loan charge. In judicial review proceedings the Court of Appeal upheld search and seizure warrants issued against two individual users of these schemes whom it suspected of offences of fraud by false representation and cheating the public revenue (see *Ashbolt and Arundell v HMRC and Leeds Crown Court* [2020] STC 1813).

On the civil litigation side, HMRC points out that it still has thousands of open enquiries into users of disguised remuneration schemes, some of which may still come before the tribunal.

One case currently before the Court of Appeal, *Hoey v CRC*, deals directly with the issue of whether HMRC has the right to tax an employee, and not the employer, in a disguised remuneration scheme, one of the biggest legal issues yet to be resolved.

If HMRC is successful in bringing a series of civil and criminal cases against disguised remuneration schemes, we could see the practice go the same way as sideways loss relief.

But do not expect that to happen anytime soon. HMRC first opened its enquiry into the tax returns of Rangers Football Club in 2004, yet it was not until 2017 that the Supreme Court finally resolved the case in favour of HMRC.

In 2005 HMRC opened an enquiry into Carbon Trading Positive Ltd, which finally ended in the conviction of Michael Richards and his co-conspirators in 2017. In that case it took seven years to bring the case to trial after the defendants had been charged. There were long-running disputes over disclosure and, at one point, a High Court judge stayed the proceedings as an abuse of process, only for them to be re-instated at the Court of Appeal. The trial itself took 11 months. One of the jurors managed to conceive and give birth to a child during the course of it.

Justice delayed is justice denied

The old saying of justice delayed is justice denied was never more true than with disguised remuneration. The decisions of the tribunals in *Dextra*, *Sempra* and *Rangers* meant that for the best part of ten years, the tax tribunals supported an interpretation of the law that was later found by the superior courts to be wrong.

In the interim, thousands of people were brought into disguised remuneration schemes having been reassured by senior lawyers and accountants that the structures they were entering into were perfectly legal.

Had the tribunal's interpretation of the law been corrected more quickly, many thousands of people may have been spared the stress and anxiety arising from their involvement in a tax avoidance scheme.

What the story of disguised remuneration demonstrates beyond any doubt is that the pitifully slow progress of tax disputes is a source of real injustice and an issue that needs to be addressed.

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