Analysis

Amendments to the 2019 loan charge: work in progress

Speed read

In November 2017, the legislation establishing the 2019 loan charge was passed by Parliament. This legislation gave rise to serious misgivings about its scope and impact. An independent enquiry was established. The Morse report was published on 20 December 2019. The report recommended and the government agreed to significant changes. They can only be implemented by subsequent amending legislation having retrospective effect. The first batch of draft legislative changes has been issued. Further amendments will follow. How far the scope and impact of the original legislation are to be cut down by its retrospective recasting will depend upon the interpretation and application of the revising legislation.

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A legislative orphan

The 2019 loan charge legislation in F(No.2)A 2017 Schs 11 and 12 was unique. There has been nothing remotely like it in British fiscal history.

The legislation is to be amended with retrospective effect, with the purpose of reducing significantly its scale and impact. This is to give effect to the recommendations of the *Independent loan charge review: report on the policy and its implementation* (the 'Morse report'). The first instalment of the draft legislative changes was issued on 20 January 2020 (see bit.ly/2SJAEYy).

The amended charging provisions will therefore be regarded as having been present in the Act when it was originally enacted.

One of the first acts of the Johnson administration was to make an emphatic disavowal of the parentage of the legislation, by setting up the Morse enquiry on 11 September 2019.

The 2019 loan charge has become a legislative orphan.

A quick-fix solution

The loan charge 2019 was announced in March 2016 and introduced in legislative form with effect from 16 November 2017. The tax charge thereby imposed only took effect on 5 April 2019 for the year 2018/19. In the case of individuals, the tax would only become payable on 31 January 2020.

What the legislation did was to extend the disguised remuneration (DR) rules back from 6 April 2011 (when they took effect) to 6 April 1999, and then make all accumulated tax charges only payable on 5 April 2019 as employment income of 2018/19. This charge applied in all cases where a loan was outstanding on 5 April 2019 to which the DR rules applied, or would have applied, if they had been in force at the time in question. The charge applied automatically. Normative expectations of procedural justice, represented by rules on enquiries, time limits and discovery assessments were inapplicable.

The expectation was that this measure would rarely be applied in practice. The legislation was held over offenders *in terrorem*, so they would in the ensuing 18 months seek a settlement with HMRC. This was a little like a crocodile inviting you to join him in the river for a nice swim. In order to settle loan charge liabilities, it was necessary for the taxpayer to make what was, without humour, called 'voluntary restitution' to meet tax liabilities for other, closed years. Settlement cases formed the exception. On 5 April 2019, to the discombobulation alike of taxpayers and HMRC, the 2019 loan charge took effect. This left a large number of individuals with historic tax liabilities which in practice they could not meet. Most were in lower to mid-income groups.

The 2019 loan charge was a quick-fix solution, designed to put an end at a stroke to loan-related remuneration for employment, with a minimum of appeal rights.

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Frankenstein's monster

Parliamentarians came to recognise that they had played the role of Frankenstein in producing an uncontrollable monster. The Loan Charge All-Party Parliamentary Group, consisting of 188 MPs, published its final report in April 2019. The All-Party Parliamentary Group's report described HMRC as 'an organisation out of control' (para 209). The report concluded that the loan charge legislation 'rides roughshod over the entire tax system, undermining basic and fundamental tax payer protection' (para 329).

These conclusions were embodied in the unanimous motion of the House of Commons passed on 4 April 2019, which sought an independent enquiry (HC Debate 4 April 2019, vol 657, 1287).

The *Cartref* judicial review

A number of those affected by the 2019 loan charge brought judicial review proceedings, seeking a declaration of incompatibility of the legislation with the European Convention on Human Rights in accordance with Human Rights Act 1998 s 4. Compatibility is about proportionality, i.e. about the relationship between means and ends.

However, in *R (on the application of Cartref Care Home Ltd and Others) v HMRC* [2019] EWHC 3382 (Admin), the application for judicial review was dismissed.

Publication of the Morse report

That was on 13 December 2019. Then, on 20 December 2019, three things happened:

- The Morse report was published. This recommended major changes to the legislation.
- The government issued its response, accepting 19 of

the 20 recommendations of the report.
- HMRC then issued its guidance on the implementation of these changes. These included the dispensation that self-assessment tax returns with a 31 January 2020 filing date could, if affected by the loan charge, alternatively be filed by 30 September 2020 without interest or penalties for late filing.

The changes take retrospective effect, being deemed to have come into force on 5 April 2019.

On one view, they constitute official recognition that the original legislation was disproportionate, notwithstanding HMRC's arguments to the contrary in *Cartref*. Otherwise it would not have been necessary to change the law. Indeed, the Morse report aimed to make the loan charge 'proportionate and fair' (page 6). However, the legal answer is likely to be that the legislation, once amended, will never have existed in its original form, so the question whether the legislation as first enacted was disproportionate, has become academic. However, not everything that has happened in the intervening period can be undone at a stroke of the lawyer's pen.

The proposed changes

There are some 50,000 to 100,000 existing cases affected by the changes, though one needs to be aware of the danger of the dehumanising consequences of referring to individuals as 'cases'.

These may be divided into the following groups:
- pre-9 December 2010 cases;
- 9 December 2010 to 5 April 2016 cases;
- close company schemes;
- residual cases;
- settlement cases;
- inheritance tax cases;
- *RFC 2012* cases; and
- interaction with FNs/APNs

In all cases, the key date is the making of a loan by the third party (P) through whom employment income was channelled from the employer (B) to the employee (A). This is the 'relevant step' or deemed relevant step within the DR rules, inserted with subsequent amendments in ITEPA 2003 Part 7A.

Pre-9 December 2010 cases

The Morse report recommended that the retrospection period should be reduced from 20 to nine years: 'the Loan Charge should not apply to loans entered into … before 9th December 2010' (page 4).

Accordingly, with effect from 5 April 2019, for 'on or after 6 April 1999' the words 'on or after 9 December 2010' are to be substituted (F(No.2)A 2017 Sch 11 para 1). All arrangements involving what would have been 'relevant steps' if the DR rules had been in force before 9 December 2010 are removed from the 2019 loan charge and cannot give rise to any income tax or NICs liability under that head of charge. For those concerned, the war is over.

The Morse report fixed on the date of 9 December 2010 because that was the date on which the government announced the introduction of the DR rules in Finance Bill 2011.

9 December 2010 to 5 April 2016 cases

The second major change is that arrangements entered into during the period from 9 December 2010 to 5 April 2016 should also be removed from the charge, provided that at the time the normal enquiry window closed (i.e. 31 January 2018 for 2015/2016; 31 January 2019 for 2016/2017; 31 January 2020 for 2017/2018):

(a) the taxpayer had '*made reasonable disclosure of their scheme usage*', and

(b) HMRC had not opened an in-time enquiry into the return under TMA 1970 s 9A (Morse report, page 5).

'Reasonable disclosure' is defined in F(No.2)A 2017 Sch 11 new para 1B(5) as such disclosure as:
- identified the loan or quasi-loan;
- identified the person to whom the loan was made;
- Identified the arrangements pursuant to which the loan was made; and
- disclosed a potential liability to income tax in the year concerned.

The first three requirements are straightforward. However, the final requirement needs to be quoted in full. It is set out in para 1B(5)(d), (emphasis added):

'(5) … a tax return contains a reasonable disclosure of the loan or quasi-loan if–

'(a) …

'(b) …

'(c) …

'(d) it contains such other information as is *sufficient* for it to be *apparent* that *a reasonable case could be made* that for the relevant year A is chargeable to income tax on an amount that was referable to the loan or quasi-loan.'

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These requirements are cumulative. On one view, provision (d) is simply summative of (a)–(c). If (a)–(c) have been satisfied, their effect will be to satisfy (d). On another view, the information in the return has to spell out that that the result of (a)–(c) is likely to be taxability under the DR rules.

The flexible and subjective terms in which the sub-paragraph is drafted mean that HMRC will have a large measure of discretion in deciding whether the contents of the self-assessment tax return amount to 'reasonable disclosure' of loan charge liabilities.

A major difficulty with this category is that many of those concerned were not required to submit a self-assessment tax return in the years in question, or will now need to complete returns for six years.

Close company cases

The DR rules, and so the 2019 loan charge, apply to three categories of cases:

(i) senior employee cases (EBT schemes);

(ii) contractor cases (nurses, teachers, lawyers, IT consultants, locum GPs, building workers); and

(iii) close company schemes.

Under the amended legislation, the senior employee and contractor schemes come within the DR rules from 9 December 2010, and so under an obligation to make disclosure.

The close company schemes were brought into the DR

rules by FA 2018 s 11 and Sch 1 para 2. This took effect on 6 April 2018. It inserted ss 554AA–554AF into ITEPA 2003, creating the 'close company gateway' in the DR rules. So, the loan charge also applied to these schemes with effect from 6 April 1999.

Participators in close company schemes could not therefore have made or failed to make 'reasonable disclosure' before 6 April 2016, because as regards the 2019 loan charge they had nothing to disclose.

Residual cases

The residual cases comprise:

- pre-6 April 2016 cases where there was no reasonable disclosure; and
- all post-5 April 2016 cases.

The 2019 loan charge, as subsequently modified, applies in both of these situations.

Another unusual feature of the original legislation which the Morse report noted was the 'stacking of years so that income received as loans across multiple years is taxed as if it was all paid in one year'. Taxpayers should be given the option of 'unstacking' the loan balance and spreading the charge over three years (page 5).

Loan balances outstanding at 5 April 2019 can be split so as to spread the liability over three years from 2018/19 (F(No.2)A 2017 Sch 11 para 1A). An election is necessary to obtain this treatment, which must be made by 1 October 2020. Also, the information requirements of Sch para 35C (or the Sch 12 equivalent) must be fulfilled. In these cases, one-third of the outstanding loan should be entered in the 2018/19 self-assessment return.

The legislation also removes the charge to late payment interest for taxpayers who are liable to the loan charge for the period 1 February 2020 to 30 September 2020, where a self-assessment return for 2018/19 is filed by 30 September, in accordance with the facility to file late returns for 2018/19 by 30 September 2020.

The Morse report made, and the government accepted, a number of important recommendations about limiting liability to affordability on a yearly basis. These have not so far been set out in the revised legislation, and they may be confined to the way in which HMRC exercises its powers.

Settlement cases

In these cases, in relation to:

- deemed relevant steps taken before 9 December 2010; and
- relevant steps taken in the period from 9 December 2010 to 5 April 2016 where there was 'reasonable disclosure',
- payments of 'voluntary restitution'

clients will have made over-payments. These are to be repaid, though the necessary draft legislation is not yet released.

Inheritance tax cases

In relation to contractor and senior employee cases, where a loan trust exists for ten years, a ten-year periodic charge or exit charge to inheritance tax may be incurred. If one or more persons fail to meet his or her liability as beneficiary, the individual qua beneficiary continues to be liable for any unsettled inheritance tax up to the value of his or her interest. This possibly unintended fiscal consequence could be removed by excluding property to which the loan charge applies from the definition of 'relevant property' in IHTA 1984 s 58.

RFC 2012 cases

The decision of the Supreme Court in *RFC 2012 plc (in liquidation) v Advocate General for Scotland* [2017] STC 1556 was handed down on 5 July 2017. This held that the sum in question had been paid as employment income at the time when the income had been 'diverted' to a third party. The decision moved back the time of payment of employment income from the provision of benefit by the third party to the diversion of income to the third party. In effect, this made the DR rules redundant, by holding that the charge to PAYE income tax and NICs was incurred before any 'relevant step' under the DR rules was taken.

FA 2018 Sch 1 para 1 sought to deal with this interaction by inserting ITEPA 2003 ss 554A–554C with effect from 29 November 2017. These sections provided that, if tax was paid on diverted earnings, it should be available as a credit against a subsequent tax charge under the DR rules. Accordingly, the exoneration of a loan from the 2019 loan charge under the amendments to the 2019 loan charge legislation does not mean that an independent charge cannot arise under the diverted-earnings rule, though that would be subject to ordinary rules on time limits and the conditions for discovery assessments.

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Thus, in some cases, the taxpayer will escape the Scylla of the 2019 loan charge only to be wrecked on the Charybdis of the diverted-earnings rule.

The interaction of the 2019 loan charge and FNs/APNs

The drafting of FA 2011 Sch 11 paras 23, 24 arguably produced a double charge to tax where a follower notice/ accelerated payment notice was issued in relation to a loan charge liability. Paragraphs 20, 21 and 22 have been omitted, and para 23 amended. However, the changes do not address this point.

Conclusion

The Morse report noted that 'the UK is one of the most tax-compliant countries in the world'. The loan charge risked 'a breakdown in proper co-operation between taxpayers … and HMRC' (page 7). 'Trust in HMRC is an important part of the integrity of the tax collection system' (page 11).

The government's acceptance of the Morse report proposals is a welcome step towards putting these matters right, but it remains work in progress. ■

- Changes to the loan charge following the Morse review (David Pett, 15.1.20)
- Comment: In defence of the 'outstanding loan' charge (David Pett, 3.9.19)
- Comment: Why the loan charge is unfair (Keith Gordon, 23.9.19)
- Treasury restricts loan charge following review (8.1.20)
- The *Rangers FC* case: payments to remuneration trust were themselves remuneration (David Goldberg QC & Nigel Doran, 13.7.17)