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Business law untangled podcast

Episode 5: How that seemingly “legitimate” tax scheme can land directors in hot water years later

Stephen Downie	Hello and welcome to this podcast by Francis Wilks & Jones. My name is Stephen Downie, and I’m here today with my colleague Maria Koureas-Jones and we are here to talk about tax.
Maria Koureas-Jones	Hello to our listeners. Today we are discussing taxation and, more particularly, how the avoidance of tax - even where you have been professionally advised - can land you in hot water some years later.
Stephen Downie	Yes, and perhaps what we see most commonly is directors getting involved in well-advised tax schemes where they believe they have been very clever and protected themselves only for parliament to go and create legislation which changes the law that applied in the past. And so, what was previously a very clever and well-thought-out route, now becomes an illegal activity.
Maria Koureas-Jones	Stephen, it sounds unfair doesn’t it? But the principle is to deal with the mischief and prevent people from trying to use some sort of complicated scheme to ultimately pay less tax. For years, HMRC has dealt with this by constantly changing the tax legislation that governs how tax is collected from employee income - which we will refer to as ITEPA – only then for creative accountants and tax professionals to design a scheme which tries to get around the legislation.
Stephen Downie	Yes, but HMRC has wisened up to this, bringing in legal provisions that require payment of some or all such liabilities before you get into discussions with them – for example the accelerated payment notices, and making anti-abuse rules more generic and aimed at the overriding objective of preventing the avoidance or evasion of tax. In other words, if you received income for such services provided, the idea is that you must deduct tax on any such income received in respect of those services you provided.
Maria Koureas-Jones	So, who is liable for such taxes? For wave deductions where PAYE and NI are due, although most of the contributions come out of an employee’s pay packet, the liability to pay PAYE and NI actually sits with the company.
Stephen Downie	Along with other company liabilities, taxes due on directors’ loans are payable by the company as well as corporation tax, VAT and CIS deductions.
Maria Koureas-Jones	As we know and addressed also in our first podcast, it is the duty of directors to ensure that taxes are paid, either in full or in fair and equal in measures to other unsecured creditor liabilities. If the director does not ensure that the company complies with these obligations then there can be personal consequences for them.

Stephen Downie	Nicely put - such a lawyer! For the majority of profitable companies, these risks do not immediately appear likely. However, if HMRC then serves notices to pay the tax liabilities due on these sums and this eventually results in a company facing financial difficulties in paying these huge demands, then there will be a later, retrospective analysis of the director and their professional advisers' conduct and that becomes a very real risk in making decisions now when bearing in mind the consequences in the future.
Maria Koureas-Jones	Stephen, can these company liabilities be transferred to individuals, either the employees or the directors personally?
Stephen Downie	Well Maria, for companies, the PAYE liability can be assigned from the company to the employee in rare circumstances under tax legislation that has been around since the 1990s. Such an assignment can be made unilaterally by HMRC where it considers such liabilities were deliberately created, particularly where it was for the employee's benefit.
Maria Koureas-Jones	And there is of course also IR35 which can have a similar effect, particularly where individuals set up a company to do what is otherwise employed work. IR35 is more of a twenty-plus year old HMRC provision that interprets the ITEPA provisions to address circumstances where a company is used by an individual who works only for one employer to reduce the tax payable on their income. They are paid income gross, may set various lifestyle expenses off against this income as a company expense and then devise different legitimate routes to reduce the tax payable, paying themselves up to their tax-free threshold, paying their family members as employees up to the same threshold, paying dividends to them and other members of the family up to the dividend tax-free amount and then paying further dividends at a lower level of taxation. This is not how employment by one employer of one employee is supposed to work and has been an abuse of the provisions available to companies who really should be businesses trading in the open market which has occurred for a number of years.
Stephen Downie	Some would describe this as instead good tax planning Maria. IR35 does not mean that trading for a company is strictly prohibited and each circumstance is different, but it is part of a taxation structure the outcome of which appears to make a company's director possibly personally liable for company taxes.
Maria Koureas-Jones	Yes, and there are lots of other rules which can lead to similar consequences. So, for unpaid national insurance - and this includes unpaid national insurance of an entire company - if a company is placed into an insolvency process, HMRC may issue initial enquiries to a director so HMRC can form a view regarding whether the director or company had failed to pay the national insurance.
Stephen Downie	Yes, and we have seen a few personal liability notices or 'PLNs', as we call them. The key with these types of issue is to get assistance in responding to HMRC early. HMRC is comprised of human beings and they will often listen to reasonably well-thought-out arguments provided you engage them early enough. If it is too late then you may miss the boat and, if HMRC determines that the NI debt was deliberately incurred by a director in accordance with the appropriate legal criteria and

	that that director was responsible for the debt, then the director may be served with a PLN which can be a very large sum of money which they thought they had left with the company but which they now are personally liable for.
Maria Koureas-Jones	So, making them personally liable for the NI liability or such proportion of it that HMRC considers was attributable to their reckless behaviour?
Stephen Downie	Yes, so, like death, these taxes are unavoidable.
Maria Koureas-Jones	And there are of course other options available to HMRC if a company enters an insolvency process owing taxes where a director sets up a new company so HMRC can seek security from the new company normally soon after start-up against both the VAT and PAYE bill. The PAYE aspect is quite a recent requirement bought in in around 2018 but the VAT one has been around for quite a while.
Stephen Downie	Yes, so the trouble with these demands is that for a breach of any security required, particularly for VAT, then the criminal penalty against the director personally is £5,000 per invoice. Taking one of the examples I have seen, the client was a director of a company that was placed into insolvency for purely innocent reasons - I mean, insolvency is not illegal, and it is a commercial part of our business environment. However, in this case, as with many other directors, he continued in business and with the entrepreneurial spirit he had he set up a new company which had some great initial success. As with any new start-up, the funding was delicate and initial profits were reinvested to enable the new company to grow. This was not an unusual pattern; many millionaires and billionaires have a history of corporate insolvencies before they developed the right formula to create ultimate success and their millions of pounds.
Maria Koureas-Jones	Stephen, can you tell us about any other examples that you have dealt with?
Stephen Downie	Yes, there are quite a few PLN security examples that I have dealt with and the whole team has dealt with. They always come as a very big shock to directors. In one case, the director had an insolvent company then set up a new company which was very strong but was then faced with a VAT security requirement which was more than £300,000 and that requirement for security against future VAT liabilities was a value based on the old company's turnover. The client initially sought to continue trading so that the company could continue to contribute towards this bill but there came a point when the security was determined, and a notice of requirement was issued and the client - or rather the director of the client - immediately became liable for a potential £5,000 criminal fine with each invoice issued. He was sending out 10-20 invoices a week whilst simultaneously trying to negotiate this security. This was obviously very serious: unless he resolved the situation he would have to close the business down and that would defeat the whole purpose of the security and indeed the security would become due because security is effectively a deposit on account and if the company ceased to trade then it is repayable. In the end we became involved and extended the deadline under the notice of requirement. We negotiated on the security value and ultimately HMRC agreed to withdraw the notice of requirement and decided not to seek any such security, allowing

	the client to continue trading. This doesn't always happen, often we get it reduced considerably or withdrawn but if it is not dealt with early enough then there can be a problem. I would ideally prefer that companies placed into this situation came to us a lot earlier.
Maria Koureas-Jones	So, the examples indicate some of the real successes. The problem of course that we see with security is that the tax man bases the security demands on the old company's income. The new company often isn't yet earning anywhere near that level and may indeed also have far fewer employees than the old company. HMRC just assumes the new company is trading with the same figures. So, in our experience negotiation is the key and often we find that we can considerably reduce the security sought or even demonstrate that there is no need for such security at all.
Stephen Downie	Yes, but as with all these types of risk directors may also be pursued for losses to HMRC akin to claims where they are considered to have acted in breach of their fiduciary duties and these types of claims can be brought simultaneously.
Maria Koureas-Jones	Absolutely and, to add further concern, this can often reflect an allegation of misconduct by the director, for example, in director disqualification proceedings for failing to treat HMRC equally to other unsecured creditors. There is a great deal of protection aimed at preventing HMRC from being the last in the queue for payment.
Stephen Downie	Yes, and against this background we move onto the meat of our discussion today which is tax avoidance schemes. I think the listeners may know of this from the first well-publicised problem which was about 10 years ago when Jimmy Carr was using a Code 2 tax avoidance scheme.
Maria Koureas-Jones	Absolutely. There are lots of schemes out there and, in summary, the purpose of all of them, no matter how complicated they seem to be, is to avoid the income of a company being paid directly to an individual as income, usually a director, but instead allowing payment to an individual via an alternative payment mechanism which is not described as income.
Stephen Downie	So, in summary, they are seeking to avoid paying tax.
M K Jones	Absolutely.
Stephen Downie	Likely the director draws a minimal tax-free salary but no more, doesn't draw dividends and instead gets their income from other sources which, because of the nature of the receipt, are not taxable.
Maria Koureas-Jones	That's right Stephen. Money for nothing - well no taxes anyway. But I am unsure that these directors get their kicks for free. I say this because liquidators and HMRC are pursuing directors for the losses caused to HMRC being either the entire amount paid under the scheme plus interest or payment of a 50% tax on sums drawn by the director through the scheme going back to 2010 which is commonly referred to as the loan charge.
Stephen Downie	So, Maria, what are the most common types of way of receiving such tax-free monies through these schemes?
Maria Koureas-Jones	The most popular scheme that we are seeing is an employee benefit trust or EBT. So, in

	that case, the company places funds into the EBT which is usually an offshore trust, the trust then provides a loan usually to a director with an indemnity for any tax liability that arises. The director, as with anyone else who takes the loan, doesn't pay tax on the loan and so doesn't have to declare it as income. As the trust company is offshore with little financial or other regulation the recovery of the loan is not policed and indeed the loan is never repaid.
Stephen Downie	Yes, and there are other similar schemes. One is an employee financed retirement benefit scheme or EFRB and they do something similar but in the guise of an unregulated pension scheme designed to benefit the company's directors as pension payments without the legal restrictions applicable to regulated pensions on the age of which you can draw down the maximum amount that can be paid in or the investments that the pension scheme can make.
Maria Koureas-Jones	And then there are share option schemes. These are often referred to for example as Eshare schemes. We have dealt with where a director or shareholder is allotted additional shares - often an E-class of shares - but does not pay for them and indeed uses the balance to offset against income drawn. The common characteristic of these schemes was the issue of a new class of shares which the director did not pay anything for or paid a very small proportion for so, for example, paying perhaps a penny in the pound for each share leaving 99 pence for each share unpaid.
Stephen Downie	Yes, so in many instances we see the director offset the payment due against the director's loan account which is fine where the company continues to trade solvently in the good times, but it raises risks if the unpaid shares remain outstanding going into the future when circumstances may change.
Maria Koureas-Jones	So, as an example, if the company goes into an insolvency process the administrator or liquidator can call on the directors to pay any unpaid share capital. In most cases, many shares were issued - hundreds or thousands - so the demand being made against directors by liquidators or administrators is often significant and can be tens if not hundreds of thousands of pounds.
Stephen Downie	Yes, and then there are the film schemes where government grants are sought, and artificial losses are created to set-off any tax liabilities and there are also back-to-back hedge schemes where the company invests in a derivative product on a short option and the director buys the other side of the option with the company losing the bet and the director winning what is effectively an unlosable bet.
Maria Koureas-Jones	So, regardless of which scheme has been utilised HMRC or an insolvency practitioner or perhaps the court depending on which stage your at will ultimately look at what the benefit of the transactions was from the company's perspective.
Stephen Downie	Which takes us nicely back to the directors and their personal liability for breaches of their duties to the company. Ultimately, where the company is solvent and trading conventionally these directors owe fiduciary duties to themselves. So, it is unlikely for a solvent trading company that they will ever be considered to be in breach of these duties but where the company is later placed into insolvency particularly where these assets were not left in the company then the director could then be regarded retrospectively as in breach of their duties to the company and its creditors to whom the directors owe a fiduciary duty where the company is

	insolvent. Nothing in life is simple!
Maria Koureas-Jones	So, this takes us nicely into the claims that HMRC has in respect of tax avoidance schemes and the final decision of the Supreme Court in the Rangers case which altered this area materially back in 2017. Historically the use of tax schemes was utilised as a way of mitigating corporation tax and it was only since around 2011 that they served a dual purpose to also reduce income tax predominantly for the director's benefit. HMRC faced initial difficulties with capturing the non-tax effect of these schemes particularly back in the noughties where the predominant use was to claim all payments under the scheme as business expenses and the 2011 Finance Act sought to resolve this by requiring that any such expenses must have accounted for income tax.
Stephen Downie	OK, but ultimately the Tax Tribunal has heard a case brought in respect of a tax advisory company, the Mirror Group, where HMRC argued that the use of an EBT to pay income to the football players of Glasgow Rangers Football Club was not legal and that such payments should have been taxed. The opposite argument on behalf of the advisers i.e. the Mirror Group and its clients the football players and their football club were that this income was paid legitimately through the EBT scheme that was utilised and was tax deductible as an expense and was not income and therefore not subject to taxation under the ITEPA provisions which Maria mentioned earlier. Strangely enough the Tax Tribunal and the Upper Tax Tribunal initially agreed with this latter analysis that no income tax was payable and that it was a valid corporate company expense.
Maria Koureas-Jones	But we won't go into detail regarding those authorities. Needless to say, HMRC appealed all the way through the specialist Tax Courts to the Supreme Court and the final decision was that the company was liable for the PAYE due and the NI due on this income and so, as of 2017, that was it, it was sorted, and the company had to pay PAYE and national insurance contributions on income and the tax schemes were then ineffective at avoiding income tax and NI.
Stephen Downie	Or were they? Well, if only it was that simple. Many of the schemes we have briefly discussed were not settled by this decision which mainly referred to the EBT and its effect on the company. Yes, the company became liable for the income tax due on the salaries paid through the EBT but how did you ultimately recover against the beneficiaries? There have since been many tax tribunal decisions making determinations on different types of tax avoidance scheme as we have discussed but, from our perspective, when advising both directors who have entered such schemes and stakeholders such as liquidators trying to recover assets lost as a result of the gross payment through such schemes, the ultimate question is: what happens if the company cannot pay HMRC the PAYE and NI due that should have been paid originally?
Maria Koureas-Jones	Well this was addressed by the tax legislation subsequently brought in in 2017: The Finance Acts (there were two of them) and the restrictions on these powers brought in

	with the Finance Act 2020. The timing very conveniently followed the Rangers case.
Stephen Downie	This is the loan charge. This provides for a 50% charge of all sums paid to the beneficiaries under such a tax scheme as the tax due to HMRC and it is a statutory charge on the income paid through the scheme.
Maria Koureas-Jones	And it is in addition to the PAYE and national insurance contributions liability already payable by the company under the Rangers decision that we just discussed.
Stephen Downie	So effectively you could be looking at this as a form of double taxation.
Maria Koureas-Jones	Potentially, yes.
Stephen Downie	The important thing to understand is that a loan charge is against the company, not the director or beneficiary although, ultimately, the perception that it is a director's liability will be correct. HMRC will have to first make a determination against the company and then seek to assign that claim from the company to the beneficiaries or directors in a similar way to the assignment of the PAYE liabilities which we discussed earlier.
Maria Koureas-Jones	So there should be plenty of opportunity to resolve these problems before it becomes a real issue for the directors who are likely also to be struggling because of, for example, the Covid pandemic and the subsequent fall-out.
Stephen Downie	Yes, and that brings us to the point as to how a director resolves such problems.
Maria Koureas-Jones	Well, we know there was a deadline of September 2019 for settlement of the loan charge aspect but, because of Covid-19, this was extended to September 2020.
Stephen Downie	And that was for settlement of the loan charge. But what has happened to those who haven't settled or who dispute the loan charge?
Maria Koureas-Jones	Well as it stands, HMRC has been a bit delayed by events over the past two years as you would expect but they are looking to get on top of this and we expect determinations against companies that use these tax avoidance schemes and who have not paid the loan charge to be issued very soon. Once a determination is made, the debt can then be assigned to the director or beneficiary and the liability is then incurred.
Stephen Downie	So timing is important, especially where the company is in an insolvency process such as liquidation. The problem is that the director faces a risk of being pursued for both of the following: Firstly, the gross payment due under the tax scheme, the gross income paid into the EBT or EFRB - the liquidator will pursue this or may, alternatively/in addition seek recovery of the unpaid tax loss caused to the company by HMRC's claim because effectively it is income that is being paid gross to the director or employee or another beneficiary. The second claim that the directors can also face - and this could be simultaneously or at a later or earlier stage - is by HMRC for the loan charge once they have determined the charge due against the company and transferred the liability from the company to the director beneficiary or other person.

Maria Koureas-Jones	And we are often talking about an enormous amount of money, potentially representing what they are withdrawing from the company in good times over a number of years, for example. But it is repayable within a very short space of time and, once HMRC seeks to enforce a debt, they pass it to their enforcement department which has no power to negotiate any settlement and, in our experience, will not stop until either the entire amount is paid, or the individual is declared bankrupt.
Stephen Downie	Which then adds another layer of costs. Even if the director has sufficient assets to pay these debts.
Maria Koureas-Jones	Yes, typical head-in-the-sand behaviour and, rather than confronting matters straightaway, directors often postpone any steps to address the issue but then later regret that decision not to deal with it when they were first made aware of the risk.
Stephen Downie	Yes, we see directors saying that to us all the time. If they do not deal with these matters head-on, we know that HMRC will consider evidence of assets, income and living costs and will even look to discuss things on a time-to-pay basis, so there is some flexibility there.
Maria Koureas-Jones	Yes, and they will also agree to enter into an agreement which works with the director's personal assets and look at whether to enter a tripartite arrangement which settles both the potential loan charge liability but also a potential claim by a liquidator.
Stephen Downie	Absolutely. But if this route is not taken early then there are considerable risks, firstly that the eventual costs will be considerably higher. Ultimately, the directors may face these claims in different orders and, rather than tying them both up in one go, they may then have to pay the second claim as well as the first. If instead they have a strong defence, the delayed timing may lead to the director having to pay the legal costs of defending two different sets of proceedings, either prior to issue or as part of a fully litigated set of proceedings. So, it is better to try and deal with this all in one.
Maria Koureas-Jones	Stephen, do you have any view regarding when the next and more serious steps are likely to be taken by HMRC?
Stephen Downie	Well I understand HMRC has been a little bit busy over the last two years with the pandemic, it still isn't over - I don't want listeners to think that we have considered the two-year period the whole period of the pandemic, it may well continue throughout later this year - but based on the past two years, HMRC has been tied up. It will not have escaped anyone's notice from what we have just said that there is obviously a statutory limitation period which applies to any claim brought under a piece of legislation. It is six years, and, for loan charge claims, it may run out in the next couple of years because the legislation was brought in in 2017, it was implemented from April 2019 and so count six years from then and you have got a pretty good idea of when that limitation period may expire and so what the pressure on HMRC is to pursue those who haven't paid the loan charge.

	Liquidators also face similar difficulties, but a liquidator's claim can be crafted to take it out of the limitation restriction in certain circumstances.
Maria Koureas-Jones	So, in summary. you are expecting in 2022 that we are going to see lots of companies receiving additional HMRC claims determined, for example, during a liquidation and claims then being presented against directors by both HMRC and possibly company's liquidators where the company has been placed into insolvency?
Stephen Downie	Yes, and this could even happen for live companies where such tax schemes have been entered. Ultimately, HMRC will follow any such demands very shortly by the inevitable bankruptcy proceedings against the individual, subject to the assigned loan charge which is a common route of enforcement employed by HMRC.
Maria Koureas-Jones	I think for now that about winds matters up for us other than to add that we have had a whistle stop tour of a rather complicated subject. Our experienced team understand these schemes, they understand the claims presented by HMRC relating to the schemes and claims presented by liquidators following use of the schemes. So we can help both directors and liquidators navigate what is a particularly complex area.
Stephen Downie	Thank you. You have been listening to a podcast by Francis Wilks & Jones about tax avoidance presented by me, Stephen Downie, and my colleague Maria Koureas-Jones. It's goodbye from me.
Maria Koureas-Jones	And it's goodbye from him.
Stephen Downie	Goodbye.