

Address to CIOT as part of 75th anniversary celebrations

- It is a privilege and a great pleasure to be asked to speak tonight because this occasion is part of the 75th anniversary celebrations of the Chartered Institute of Taxation. Just a few days ago at the CIOT Address, Philip Baker QC and Nick Montagu demonstrated two things of real importance:
 - ◆ First, the people who have made some of the biggest impacts on tax thinking from the private sector over the last 75 years have done so from the CIOT. Second, it is the CIOT that is at the forefront of developing the skills and knowledge that the UK needs in its tax specialists. Many people who become solicitors, accountants or tax inspectors now choose to follow up their first qualification with CTA.
- This is quite possibly the most momentous year in the history of tax in the UK. Not this time because it is the 75th anniversary of CIOT but because it is the year of birth of HM Revenue and Customs, the UK 's new tax department which took life on 18 April and of which I am very proud to be one of the first Commissioners.
- The O'Donnell Review which led to HMRC, as I will call it tonight, set three clear objectives for the new department – an improvement in customer focus, an improvement in cost efficiency, and closure of tax gaps.

- I want to spend some time looking at one particular aspect of tax gaps with which I have had a lot of personal involvement. I want to look back at how the Revenue has tackled the issue of remuneration in non-cash form, or put differently tax avoidance in the field of employment income, over the years and to say something about the rationale for the latest developments in this area – chiefly, the PMG’s statement at the time of PBR about closing schemes down from 2 December 2004 where necessary.
- My own involvement started in January 1996 when my colleagues in the Revenue asked me to use my compliance background to help them address this issue. I knew little about it at the time but soon realised that I needed to establish a project based approach involving tax specialists, lawyers, Counsel – a strong leader and a very effective junior, now himself a QC – and investigators from the Special Compliance Office. I have to tell you it all had a ghastly fascination. Listening to a promoter of RIOTs (reversionary interests in offshore trusts) – probably the most exotic form of remuneration ever conceived – explain how the arrangement worked was a treat. The money never quite seemed to get where he wanted it to be – and the Courts eventually thought the same! Then there is the exotic nature of some of the assets – hay and animal skins - that have been used to try to get round the deduction of PAYE and accounting for National Insurance contributions. Some schemes became totally detached from reality – for example, if everyone awarded an interest in platinum sponge had decided to hang on to it, there wouldn’t have been any platinum sponge

available for commercial use – yet the platinum sponge used for tax reasons never seemed to leave Schipol Airport or Jersey. When I wanted to buy some as an exhibit in litigation the Revenue's FD gave me very clear instructions about what I was to do if I spilled it – and I well remember the shock on the face of a director, who claimed to have got some as a bonus, when we told him what it looked like and then showed him some. And the oriental carpets used in a different scheme were not only oriental but magical – they were generally invisible and capable of being in several different places at once.

The context

- This involved a significant development of the avoidance industry (including by some members of the CIOT) – and therefore of the “anti-avoidance industry” in the Revenue and DSS to match it. I want to outline the way our work on anti-avoidance has had to develop to face the ingenuity and enthusiasm of those trying to find the opportunities to avoid paying National Insurance and defer paying tax. It is worth noting at this point that the Revenue's work spans several administrations. Most recently, a Labour Government. announcing the latest steps in their determination to put a stop to tax avoidance on employment income. As soon as they came to power, they introduced measures to “stop tax leakage” and prevent tax being “siphoned away”- as they took steps to put beyond doubt that remuneration in the form of trade debts was within the scope of PAYE

- But similar language was being used by a Conservative administration in the 1990s. In April 1995 Peter Lilley announced measures designed to stop a “National Insurance dodge” by paying employees in tradeable assets. Avoidance of National Insurance when staff were paid in their company’s own shares was described as “the latest dodge” when measures were taken in 1996 to make sure the charge applied – these measures, along with similar tax measures were described as a crackdown. So there has been political consensus that avoidance of tax and NICs on the rewards of employment – often in the context of high City bonuses – is something to be stopped in the interests of fairness and because of the amounts of money at stake.
- The recent announcement in December 2004 talked of £2bn being paid in bonuses last year. But measures to stop PAYE avoidance in 1994 Finance Act were expected to bring in £200 million. It is hard for any Government to overlook that sort of money.
- A cynic might note, as a colleague observed to me the other day, that PAYE came in in the 1940s to collect tax from the working classes because previously they spent the money and couldn’t pay. In an interesting social shift, the challenge nowadays is to get PAYE from the middle classes because they won’t pay – or at least, sometimes they need some encouragement.

The beginning

- Getting back to the practicalities, what are people trying to achieve with imaginative schemes for the payment of rewards from employment.
- First, to establish that the transfer of value from employer to employee, or from 3rd party to employee on behalf of the employer, is not something that requires the employer to account for tax under PAYE. It's usually accepted that the employees should pay tax on what they get – but that it should be accounted for under self assessment some considerable time later (or in earlier years included in their Sch E assessment).
- Second, and more important, that the transfer of value to the employee does not represent a payment of earnings to an employed earner – so that the charge to National Insurance, in particular the charge on the employer, is avoided. It is generally the potential NICs advantages that are the main driver for schemes.
- When did schemes designed to get round the PAYE and NICs rules really begin to take off? Well, for as long as NI contributions on earnings stopped being payable at the Upper Earnings Limit, there wasn't much mileage in trying to get round them – the amount of NICs at stake was capped and the tax advantage represented a deferral of payment rather than a way out of paying.

- Things changed when the cap on employer contributions was removed so that contributions became due on earnings above the Upper Earnings Limit – which stood at £265 a week in 1985/6 when the cap was lifted. That dramatically changed the potential amounts to be gained by avoiding the charge. And with no charge to NICs on payments in kind, schemes for remunerating employees in non-cash form became popular.

Early attempts and the weapons available

- There was a very exotic flavour to the schemes that sprang up following the change to the NICs rules. Employers took to paying their staff in assets of various kinds – these ranged from gold coins, gold jewellery, gold bars, platinum sponge, trade debts, through coffee beans, fine wine and Oriental carpets to bismuth – central apparently to the manufacture of indigestion remedies – and more threateningly, arsenic. Use of these schemes was not confined to large companies and the very highly paid either – there was active marketing of schemes to small and medium-sized businesses and the NICs-payer on the Clapham omnibus.
- Charming though it would be to picture an employee sticking his bottle of platinum sponge on the mantelpiece where the more traditional carriage clock for long service would have belonged, that was not of course the idea. In fact, it would be unwise since platinum sponge is volatile and needs to be stored in a stable environment, at stable temperature, without much air movement, as we learn from the case of NMB Holdings. But in

any event, the idea with all these assets was that they could rapidly and easily be turned to cash in the employee's hands. So that for practical purposes the employee had got a cash reward for his services in the ordinary way.

- The Revenue and Dept. for Social Security (then responsible for NICs) had some ways to tackle these schemes.
- For NICs, contributions are based on “earnings” in an employment. Payments in kind rather than cash can represent earnings but in fact such payments were largely excluded from earnings. To counter the sort of schemes being used to avoid NICs, there was a series of regulation changes to prevent certain types of assets being excluded from the definition of earnings. In Nov. 1991, financial instruments including shares, gilts and insurance policies were brought into charge. In Dec 1993, action was taken on commodities including gold bullion and precious metals. And again, in August 1994, alcoholic liquor (fine wines) and gemstones were brought in.
- PAYE was due on a “payment of, or on account of, any income assessable to income tax under Sch E” and the payment had to be a “payment of emoluments to any employee”. The Revenue argued that transfers of assets were within the scope of PAYE because the provisions caught the transfer of assets to satisfy a legal entitlement to a monetary amount. Cash vouchers were also covered.

So what was the problem ?

- For PAYE, there were a number of conditions to be met to show that PAYE applied. There needed to be a legal entitlement and the entitlement had to be to a monetary amount, rather than to the assets themselves. There also had to be entitlement to a payment – and we all know how the cases of Westmoreland and DTE have gone on to complicate that simple word! Demonstrating that the conditions were met was difficult and hinged on the precise wording of the resolutions voting remuneration.
- For NICs, it is apparent from the changes that were made that the effect of closing down schemes using one asset was simply to displace activity into other assets.

1994 legislation

- To break the cycle whereby the action moved elsewhere as soon as the Revenue and DSS caught up and closed down a scheme, broader provisions were introduced in the 1994 Finance Act to counter avoidance of PAYE. They were matched by changes in National Insurance regulations.
- The challenge in legislating was to hit the right target. The aim was to make sure PAYE and NICs applied to what were essentially disguised cash payments – assets intended to be converted into cash very quickly - without catching all tangible assets provided as benefits by employers. This was a tricky thing to do because we wanted PAYE to apply at the time an

asset was transferred but we could only identify transfers that put cash into employee's hands once they had actually done so.

- The new legislation obliged employers to account for the notional amount of PAYE due when Schedule E income (as it then was) was paid in the form of “tradeable assets”. PAYE had to be accounted for irrespective of whether there was enough cash salary paid that month to recoup it by deducting it from cash payments to the employee.

- The new concept of tradeable assets was defined as
 - Assets tradeable on a recognised investment exchange or the London Bullion Market
 - Assets tradeable on markets specified in PAYE regulations – the only market ever specified in practice was the New York Stock Exchange
 - Assets for which trading arrangements existed. And trading arrangements meant arrangements for the purpose of enabling the employee to obtain an amount of cash similar to the expense incurred in the provision of the asset.

- Other provisions introduced at the same time tackled schemes involving offshore intermediaries and aimed to catch vouchers, credit tokens and cash vouchers which could be exchanged for assets or were themselves tradeable assets. And a new provision reinforced the whole approach by imposing a benefit in kind charge on the employee where the employer effectively

bore the PAYE tax because there was no cash to deduct the tax from and the employee did not make good the charge in 30 days.

So what went wrong ?

- The Govt. had taken decisive legislative action to tackle avoidance on employment income. Was that the end of the story ?
- Well, not surprisingly, it wasn't – merely the start of another chapter. There were signs that some types of assets were no longer used and that some employers were now accounting for PAYE on some transfers of assets.
- But what also happened was that those in the avoidance industry turned to new and ever more artificial schemes, often involving intangible assets. And it was clear that employers continued to look for ways to pay remuneration in a PAYE and NICs-efficient way. In some cases, employers continued to contest the NICs charge while accepting they should account for PAYE.
- Moreover, it became apparent that technical challenges to the 1994 legislation were possible for some schemes and there were practical difficulties applying the PAYE charge when the taxable amount was not readily quantifiable.

What were the issues ?

- Many of the issues related to the meaning of the third limb of the tradeable assets definition – which said that a tradeable asset is one for which trading arrangements exist. In particular, the meaning of “trading arrangements” gave rise to difficulty
- We were facing arguments for a narrow construction of the legislation and questions were raised about, for example,
 - whether the employee needed to be guaranteed in advance the amount he/she would get out of selling the asset
 - whether the trading arrangements had to be in place at the time the asset was transferred – what happened if the arrangements were put in place a couple of days later ?
 - Whether to fall within the definition the employee needed to take action of some kind – was it enough for the money to arrive without any action on their part
 - What happened if the arrangements for realising cash were inherent in the asset itself – as in the case of trade debts, for example. This was a point that was commented on in the DTE case, although it didn’t affect the outcome.
- Could it be said that the arrangements were “for the purpose of” putting money the employee’s way if the

arrangements had a separate independent existence, such as the market in platinum sponge.

- What happened if the employee held on to the asset for a while before realising it ?
- At the practical level, there was a problem quantifying the amount on which PAYE should be applied if, in practice, the amount obtained by the employee was obtained after the end of the income tax month in which PAYE was to be applied.

How did Government respond ?

- We aimed to test a number of these points in litigation. And we made clear that we still took the view that the schemes which were being put forward as falling outside the scope of the 1994 legislation were in fact caught by it. But meanwhile Ministers concluded that there should be further legislation to strengthen and clarify the 1994 provisions.
- The 1998 Finance Act therefore contained further provisions to counter avoidance of tax in the employment income field. They included:
 - Putting beyond doubt that PAYE applied to income provided in the form of assignment of trade debts to employees – taking effect from 2 July 1997

- The replacement of the term “tradeable asset” with the term “readily convertible asset” and a new definition of trading arrangements
- A new measure of the amount PAYE should be applied to
- Making clear that PAYE applied when the value of an asset owned by the employee was enhanced by the employer
- A new definition making clear that the provisions also apply to former employees
- applying PAYE to
 - Sch E income derived from the exercise of share options
 - cash payments for giving up or not exercising share options
 - the new Sch E charges on conditional or convertible shares introduced in the same Finance Act.
- The definition of “readily convertible asset” was wider than its predecessor – the new definition also covered:
- Rights passing on assignment or other rights in respect of a money debt – to counter schemes, for example, involving the transfer of interests in ECU bank accounts

- Assets or rights over assets in a “fiscal warehousing regime”
 - so that it was clear assets held in bond were covered

- Assets likely to give rise to, or become a right to, an amount of money similar to the cost of providing the asset, without the employee having to do anything. This was aimed at, for example, schemes involving reversionary interests in offshore trusts - to counter the argument (which we didn’t accept) that for the legislation to bite, the employee had to take some action to realise the money

- Assets where trading arrangements are likely to come into existence under other arrangements or an understanding already in place – to make clear that PAYE bites even if the arrangements are not in place at the time the asset is transferred.

- ◆ Similarly, the definition of trading arrangements was broadened
 - for example, to make clear that it was the fact that arrangements had the effect of enabling employees to turn assets into cash that was important, and to put an end to the argument that under the arrangements the employee must be guaranteed to realise a particular amount.

- At the practical level, the new provisions said that employers should apply PAYE to their best estimate of the amount on which the employee was likely to be chargeable to tax, recognising that employers wouldn’t necessarily know in time

how much the employee actually obtained from the trading arrangements.

- Similar action was taken by the DSS on the National Insurance front to make sure their provisions stayed in step.

What next

- The additional complexity of the provisions considered necessary in 1998 illustrates the ingenuity and imagination of the tax avoider's arguments. As schemes grew more complex, so we saw increasingly detailed and complex provisions resulting from the attempt to leave no chinks of light or loopholes to be exploited.
- It is fair to say, that the 1998 legislation pretty much saw the end of schemes involving exotic tangible assets. But, in a pattern that is familiar, the effect was to displace avoidance activity elsewhere – principally, into the area of remuneration through employee benefit trusts or by way of securities, convertible securities, options over securities, conditional securities and other esoteric instruments.
- We have seen the same pattern of new avoidance schemes and counteraction repeating itself in recent years in relation to the charge on employment related securities, with increasingly intricate schemes and increasingly complex provisions to counter them. The charge is contained in Part 7 of ITEPA 2003. But there were amendments in Sch. 22 of Finance Act 2003 to tackle high risk avoidance areas, with further targeted

provisions in Finance Act 2004. And there are proposals for more amendments still on the table – chiefly, to introduce exclusions from exemptions or deferrals of a charge where the main purpose or one of the main purposes of arrangements made is to avoid tax or NI.

- I do not propose to go over this area in detail but there are some here tonight who will be thinking immediately about a scheme involving gilt futures moving in one direction and cash in the other.
- We think we have a number of arguments to counter this scheme but the proposed amendments to Sch 22 put the matter beyond doubt by introducing a deemed election under new S431B to tax gilt futures, on acquisition by the employee, on their full unrestricted MV, if such securities are part of an avoidance scheme.
- The point here is to illustrate that we are seeing the same pattern we saw with tradeable assets - of legislative action, new schemes designed to circumvent it, further legislative action and so on. It is clear that the history is one of squeezing the balloon in one area only to see a new bulge emerge in another

So where next ?

- So what is the answer to this cycle of brilliant new wheezes and legislative counteraction after the event.
- Well, litigation of course is one answer. The case of DTE Financial Services v Wilson established for example that it was right to bring a RIOTs scheme within the scope of PAYE – it was held that the Ramsay principle applied because there was a composite transaction involving three stages to pay £40,000 to the employee in question.
- We do of course want to take cases to litigation to establish the PAYE and NICs charge. We still intend to do so for example, for cases involving transfers of assets or those involving payments through employee benefit trusts.
- But litigation is **slow** – it takes time to get a case before the Courts and for all the stages of litigation to be worked through. The Court of Appeal judgement in DTE was given in 2001 in respect of a determination for 1995/96. We believe we have right on our side but it takes time for that to be demonstrated.
- Litigation is also **risky**. For example, in the case of Tullet & Tokyo Ltd v. Secretary of State, it was found that a NICs charge did not apply to the payment of additional premiums by the employer on an insurance policy the employee already owned. Collins J reached his decision with reluctance, noting that “many might think that the reality of the situation ought to produce a different result”. That particular case, being an appeal from the Secretary of State’s determination, could not go

beyond the High Court. It is also to be noted that the Ramsay principle was not argued in the case as it had not been argued at the earlier stages.

- Ramsay was argued in the case of NMB Holdings which concerned payments by way of platinum sponge. It was confirmed there that the Ramsay principle could be applied to National Insurance. And it was found that “What there was was a decision to pay and the actual receipt of cash bonuses with an artificial scheme created in the middle whereby the money went into and out of platinum sponge in the course of about 24 hours. Looked at as a whole that is, in my judgement, tax avoidance, not tax mitigation.”
- Helpfully, it was also noted that :
 - “it is not... a legitimate limitation on the principle to submit...that, because the relevant legislation has sought to plug what are conceived to be some gaps in its provisions, therefore an unplugged gap must be taken to have been expressly permitted. That would not only be to ignore the ingenuity of tax advisers but to emasculate the Ramsay principle altogether.”
- The confirmation in DTE and NMB Holdings that Ramsay applied to NICs is helpful in addressing the charge that legislating for NICs in 1994 and 1998 was to apply national insurance in a way that was not intended. Langley J concluded:

“however described, National Insurance contributions are very closely analogous to a tax. They are a compulsory state-levy on employers and employees and the relevant legislation is of a recognisable kind in such a context.”

More broadly, of course, it was a fundamental principle of the national insurance scheme that contributions should be paid on cash earnings. It is hard to see how it can be contrary to that principle to seek to apply the charge to cash earnings dressed up to look like something else.

- Even where there have been decisive judgements like NMB Holdings, however, we have **not** found that the principle thus established has been **followed** across schemes of the same type, let alone across schemes more generally. So there is a balance to be struck between responding to avoidance by way of challenge in the Courts and finding other means to close schemes down.

The latest developments

- I hope it emerges clearly from what I have said that successive Governments have for a decade and a half been active in trying to tackle avoidance of tax on employment income effectively, in the face of sustained and inventive attempts to circumvent whatever preventive measures are put in place.
- Throughout, the Govt. has tried to take action which is proportionate – for example, in response to representations on the 1994 legislation, it excluded own company shares from the

tradeable assets legislation. Only to find that the exclusion was exploited for avoidance purposes and that it was necessary to plug the gap later.

- The most recent developments we have seen are designed to change the rules of the game so that the gamekeeper is not left in the position of always being several steps behind the poacher.
- The first of the recent significant changes has been the rules about disclosure of marketed schemes. Those rules enable HMRC to identify avoidance schemes much earlier and respond to them more quickly. They put HMRC on the front foot in dealing with avoidance and change the balance of risk for promoters of schemes. The further changes proposed to Sch 22 FA 2003 in the draft provisions made available earlier this year are based on the areas of risk exposed by disclosures under the new rules.
- By way of illustration of the sort of thing the disclosure rules are bringing to light include
 - The Silver Box scheme – which exploited legislation designed to encourage employee share participation to get round the charge on the award of shares and take dividends to avoid NI and reduce the income tax due
 - The Blue Box scheme was similar to Silver Box but involved options over gilts gifted to charitable trusts, and

exploitation of the Gift Aid rules that members of the CIOT have so roundly condemned.

- The imaginatively named Kevin which relies on the individual repaying borrowed gilts, and claiming a deduction for the manufactured interest payment that has to be made and an allowance under the accrued income scheme – generating repayment claims. Quite unlike, of course, the other well known scheme called Kevin which involved remuneration awarded in the form of restricted securities.
- Using limited liability partnerships to generate 100% first year capital allowances on information technology assets which are then licensed. The individuals get a share of the loss to set against other income. This was an example of where we were able to take rapid corrective action in the Finance Bill.
- We have scheme disclosures ranging from £250m tax at stake for a single user of the scheme to a scheme designed to avoid a maximum charge of £1,900 a year.
- So we are seeing all sorts – but the key point is that we get the tip-off early and Government can act quickly where appropriate to close schemes down.
- The second significant change recently is the announcement by the Paymaster General at the time of the PBR 2004 that the

Government remains determined to close down schemes designed to avoid charges on employment income and intends to bring forward legislation to achieve that, if necessary with the provisions taking effect from 2 December 2004.

- The statement is perhaps a measure of the exasperation and frustration felt in the face of the sustained determination to avoid PAYE and NICs on remuneration.
- But the important thing about both the disclosure rules and the statement is the way they change the balance of advantage in relation to avoidance. Instead of legislation delivered years after the schemes have had effect and biting only on those too slow to realise the game had moved elsewhere, there is the opportunity to move much more quickly to close schemes and to deny avoiders the benefit of schemes that have already been used, instead of shutting the stable door.
- I think this means a decisive change in the climate for avoidance schemes in this area. It is too early to tell for sure but the early signs are that the avoidance industry has taken a decisive knock. There has been a fall in disclosures in this area and anecdotal evidence of bonuses being paid in good, old-fashioned cash.
- Some are worried that the scope of the measures now being proposed is potentially too wide-ranging. We understand those concerns but it has been made clear that the target is those who seek to avoid the proper charges on their rewards from

employment and in particular the area of high value City bonuses paid in ways designed to avoid tax.

- Others have complained that the statement introduces uncertainty. On that point, I am tempted to quote from Jonathan Parker LJ in the DTE Financial Services case when he was considering the argument that Ramsay introduced uncertainty:

“The true position, as I see it, is that for those employers who operate the PAYE system in a straightforward manner, and who do not resort to the complexities of tax avoidance schemes, there will be neither confusion nor uncertainty: whereas for those employers who choose to operate such schemes the effect of applying the Ramsay principle is to restore the certainty which the legislature intended.”

I would say that there is certainty – but certainty that schemes will not be allowed to succeed.

- We are of course alive to the fact that the PBR statement marks a significant shift in the approach to tackling avoidance. We have no wish to make life difficult for those whose arrangements are motivated by genuine commercial considerations. But there should be no illusions about the determination to tackle artificial and abusive arrangements designed to avoid the proper charges on the rewards from employment.

- I hope this look back over the history of anti avoidance provisions in the employment income area has provided some context to the most recent developments. I think the PMG's statement marks a break with the way we have done things in the past. It will be interesting to see what happens next – has the balloon burst or should we look for a new bulge elsewhere? One thing I think is clear, however – the gamekeeper is unlikely to go back to playing the game according to the poacher's rules.

- ◆ I want to close by sending you home tonight with a single thought in your minds – the history of tax avoidance through remuneration in non-cash form is testimony to the creativity and ingenuity of the tax avoidance industry. But what if all that creativity and ingenuity had been used differently, to promote productivity and enterprise in the UK?

- ◆ Thank you for listening.