

## **“HMRC TECHNICAL NOTE**

Personal Tax Avoidance – Government taking further action to prevent artificial avoidance that uses employment income legislation

### **Introductory Note**

1. Following the Government’s response to a scheme that generated employment income liabilities, HMRC has become aware of a number of similar artificial and aggressive avoidance schemes that seek to generate losses from employment income, leading to claims for substantial repayments of tax. A [Technical Note](#) published on 12 January 2009 covered the earlier scheme.
2. The Government does not accept that any of these highly contrived arrangements have the effect that is sought. Following the Written Ministerial Statement that was made to Parliament on Tuesday 13 January 2009, the Government proposes to introduce further appropriate legislation in the 2009 Finance Bill that will also effective from 12 January 2009. This legislation will prevent claims for relief and consequent repayments of tax where the employment income loss arises from arrangements made for the purpose of avoiding tax.
3. The legislation will not affect genuine cases where tax avoidance arrangements are not involved.

### **Technical Note**

4. On 12 January 2009 the Government announced that it would be taking action to prevent tax relief being given where liabilities relating to an employment are incurred by employees and former employees with a main purpose of the avoidance of tax.
5. The Government is aware of a similar scheme or schemes that seek to exploit S11 ITEPA 2003 and S128 ITA 2007.
6. The relevant legislation is:
  - a) S11 ITEPA 2003 - The method of calculating “net taxable earnings”. The provision anticipates that in certain circumstances the total taxable earnings (before any deductions from those earnings) from the employment in a year may be negative. In such circumstances, relief may be due under S128 ITA 2007
  - b) S128 ITA 2007 – Employment loss relief against general income. A person may make a claim for employment loss relief to be set against

their general income of the loss-making year, the previous tax year or both years.

7. The Government accepts that relief may be due as a result of the interaction of these provisions where the loss arises directly from the conditions of the employment. This would occur where the employee was contractually obliged to suffer a proportion of the losses of the employer. Examples include a departmental manager remunerated by a percentage of the profits of their department and responsible for a corresponding percentage of any losses, or a commercial traveller responsible for bad debts arising from orders obtained by him or her.

8. The technical note dated 12 January 2009 outlined the Government's response to a scheme intended to exploit the provisions of sections 346 to 348 and 555 to 559. Under these provisions, deductions from employment income are allowed for the insurance arrangements or payments made in the absence of such arrangements arising from employment related liabilities such as damages and associated legal costs. Both schemes depend upon deliberate default from commercial arrangements entered into during an employment. The difference is that the relief in the earlier scheme arises from a deduction from earnings rather than negative earnings.

9. The specific tax avoidance arrangements of which the Government is aware involve the use of a number of entities including both companies and trusts some of which may be based offshore. A key element of the structure is the creation of a contrived employment with an employer that enters into financial arrangements that may take the form of stock lending with another party. Under the employment contract, the employee must bear a significant proportion of any losses incurred by the company.

10. This scheme relies on a deliberate default during the course of a contrived employment. During the course of the employment, the employer will deliberately default in relation to one or more aspects of certain financial arrangements undertaken by the employer. Under the terms of the employment, this will trigger compensation payable by the employer. The employee will be contractually obliged to suffer all or part of the compensation by the employer in respect of the default and will then claim to relieve for this as a loss against other income.

11. We understand it will be argued that the employee's contractual liability to cover the loss creates an instance where taxable income as defined in section 11(3) ITEPA is negative, so that relief may be available by virtue of section 128 ITA 2007, and that this loss can then be used to frank other taxable income or gains of the individual. The

Government does not accept that these highly contrived arrangements have the effect that is sought, but will remove the uncertainty that would be caused by any litigation to establish that by including appropriate countering legislation in Finance Bill 2009. This legislation will take effect from 12 January 2009.

12. For the avoidance of doubt, a deduction for expenses of an employment incurred wholly, exclusively and necessarily in the performance of the duties of the employment is allowed under S336 ITEPA against the earnings of that employment. S329 ITEPA 2003 ensures that any deductions cannot exceed the earnings from that employment.

### **The legislation**

13. This new rule will apply to claims to loss relief where the loss was incurred on or after 12 January 2009, whether the arrangements that resulted in the loss were entered into before, on or after that date.

14. The new rule will not apply to claims to employment loss relief made before 12 January 2009.

15. Loss relief will still be available where there is no main purpose of avoidance of tax. So those who are not engaged in tax avoidance arrangements will not be affected by the change.

16. It is known that some individuals have entered into arrangements of the type outlined at paragraphs 9 to 10 of this note with the intention of creating losses in 2008/09, and in some cases have claimed for those losses to be set off against taxable income for 2007/08.

17. The legislation set out in the accompanying draft today imposes a test, effective from 12 January 2009, that where an employment loss relief claim under section 128 ITEPA is for the purposes of avoidance of tax that claim will be disallowed.

### **Penalties**

18. It is HMRC's view, that in those particular cases where individuals have made a claim for losses to be set off against taxable income for 2007/2008, it is highly unlikely that penalties for negligence will arise where taxpayers have followed the professional advice given to them. We will put this beyond doubt by incorporating into legislation protection for taxpayers from penalties resulting from this announcement between the 12 January and the date of this announcement.

## Surcharges

19. Our understanding is that some individuals, on the basis of professional advice which drew attention to the possibility of a surcharge being due if the scheme were successfully challenged, will have paid any 2007/08 tax balance due without taking into account the contrived losses.

20. Where the individual has instead chosen to pay less than the balance due on the basis of the scheme being effective, that individual will be liable to a surcharge under Section 59C TMA. We will legislate to protect taxpayers from surcharges that arise between the 12 January and the date of this announcement as a result of this announcement provided they re-order their affairs in accordance with this announcement within 28 days of this announcement.

22. Example 1 below illustrates circumstances where the new rule will prohibit a deduction and where no penalties or surcharges will be sought by HMRC.

23. Examples 2 and 3 illustrate circumstances where the new rule will not come into play and relief will continue to apply as before.

### Example 1

Individual F expects to have substantial income for 2008-09 and wishes to shelter it from tax. F therefore enters into arrangements that have been marketed by a tax adviser who promotes avoidance schemes that are designed to create a loss of £500,000 that can be set off against general income under section 128 ITA 2007. F plans to set the loss of £500,000 against general income of 2008-09 in order to reduce the amount of general income on which he will pay tax from £520,000 to £20,000.

### Example 2

Individual G is a director of trading company A. His employment contract states that the company can reduce his employment income by the amount of any bad trading debts owed to the company. In the year in question, the relevant bad debts exceeded the remuneration that he was entitled to from the company. HMRC accepts that they were trading debts and tax avoidance is not a main purpose of the arrangement. He is entitled to treat this as an employment income loss and claim relief under S128 ITA 2007.

### Example 3

Individual H is a divisional manager of a trading company. His employment contract entitled him to a share of the profits of the division but also made him liable for 50% of the losses of the division. As a result of significant losses suffered by the division in a particular year,

he had to sell his home and make a substantial payment to the company. Again, HMRC accepts that they were trading losses and tax avoidance is not a main purpose of the arrangement. He is also entitled to loss relief that can be set against general income under S128 ITA 2007.”