Statutory safeguards

Sarah Gabbai believes that the loan charge has highlighted the dangers of retrospective taxation and suggests a blueprint for statutory safeguards.


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In a written statement on 31 October 2019 announcing a proposal for a retrospective tax law relating to HMRC's use of automated processes to serve notices (tinyurl.com/y5wlg2ox) the then financial secretary to the Treasury, Jesse Norman, declared that the UK government was 'committed to doing what is necessary to protect the exchequer, maintain fairness in the tax system and give certainty to taxpayers'. The retrospective nature of the proposal must have been on his mind in reaching this conclusion, since he was also at pains to point out that the government 'introduces legislation with retrospective effect only where necessary'. This raises an important question: exactly when is legislation with retrospective effect necessary? Put another way, how can retrospective tax rules protect the exchequer and treat taxpayers fairly at the same time? And should it fail to achieve this balance, how should that equilibrium be restored?

Background

Governments have traditionally used retrospective tax rules to either fix perceived gaps in existing rules to ensure that they operate as originally intended or as a means of preventing widespread proliferation of tax avoidance schemes deemed contrary to the intent of the relevant legislation. It is the latter category that has attracted much discussion and debate recently, particularly in relation to the loan charge, the retrospective effects of which have been widely criticised by taxpayers and practitioners alike due to the unprecedented financial hardship and related mental health consequences it has created for many taxpayers.

Key points

- Purportedly, retrospective legislation should be introduced by the government only if necessary.
- The loan charge rules show that retrospection can have bad consequences.
- Retrospective law must have proper parliamentary scrutiny.
- Proposed safeguards on warnings, schemes, secondary liabilities, time limits and rights of appeal.
- Legislation that does not meet safeguards should be suspended until it is made compliant.

What is the issue?

The loan charge has shown how retrospective tax rules can have devastating consequences if they are not scrutinised properly before they are enacted. Although HMRC is right to focus on stopping promoters and enablers from marketing aggressive tax avoidance schemes, that by itself will do nothing to address the damage the loan charge has created for taxpayers.

None of the existing safeguards against the potentially harmful effects of retrospective tax statutes – whether human rights law (see *R (Huitson) v HMRC* [2011] EWCA Civ 893 and *Cartref & Ors v CRC* [2019] EWHC 3382 (Admin), the EU law principles of legitimate expectation (*Marks & Spencer v CCE* C-62/00), impact assessments or prior warnings – have thus far proved adequate to challenge the loan charge legislation, insofar as they have been properly tested. Judicial review has no relevance since statutes themselves cannot be challenged by the courts except where the statute's compatibility with EU law or human rights law is at issue – as was the case in *Professional Contractors' Group & Ors v CIR* [2001] EWCA Civ 1945 and *Cartref* [2019] EWHC 3382 respectively. Further, there is insufficient political will for repealing the loan charge. The result is that taxpayers have, in effect, been backed into a corner without any legal protections at all.

For these reasons, it is my view that the loan charge has exposed a gaping constitutional hole that can be fixed only by improving the system of checks and balances between parliament and the executive. Unlike the US, the UK does not have a well-established due process standard against which to test the constitutionality of a retrospective tax statute – a fact that the loan charge has brought to the fore.

How can this issue be resolved?

Any retrospective tax law, whether existing or proposed, must be given proper parliamentary scrutiny, with the advice and assistance of an independent specialist tax law committee, before it is allowed to become effective. To address this, I have designed a blueprint for a new set of statutory safeguards which draw on some important lessons from the loan charge. Any such rule that fails to meet these safeguards would be suspended until it is made compliant.

The proposed safeguards would address the following aspects:

1 Clear and precise warning.
2 Knowledge of a particular scheme.
3 Consequential secondary liabilities.
4 Time limits for raising discovery assessments.
5 Right of appeal.

We can now examine these safeguards in more detail.

1. Clear and precise warning

If retrospective tax legislation is being considered to stop a particular tax avoidance scheme, the government must give a clear, precise warning of the scheme it intends to target and legislate it in the next Finance Bill.

The loan charge was introduced in F(No 2)A 2017, Sch 11 and Sch 12 to tackle disguised remuneration loan schemes (DR schemes). Initially, an income tax charge was to apply retrospectively to loans made on or after 6 April 1999, but the cut-off date was later changed to 9 December 2010, being the publication date of the draft legislation that eventually became FA 2011, which introduced ITEPA 2003, Pt 7A. HMRC's justification for backdating the charge to 9 December 2010 was because, in its view, the law on DR schemes was clear from that point onwards, and that such schemes 'never worked anyway' (and thus, by implication, should have been a sufficient warning to taxpayers).

There are two issues with this. First, the idea that the schemes 'never worked anyway' is not necessarily correct as a matter of law. It is not clear that, technically, Pt 7A would have applied to render every post-9 December 2010 DR scheme ineffective; and where self-employed contractors were concerned, Pt 7A had no relevance at all. While it is fair to say that many post-9 December 2010 DR schemes were high risk and potentially susceptible to challenge – whether under Pt 7A, existing anti-avoidance case law, the GAAR or perhaps even under general principles (as proved to prevail in *RFC 2012 plc (formerly Rangers Football Club Plc) v Advocate General for Scotland* [2017] STC 1556) – that is not the same thing as saying that the law was clear or that the DR schemes never worked.

Second, it is difficult to see how HMRC's view on DR schemes could have given taxpayers sufficient warning. If governments wish to give a clear warning of a particular tax avoidance scheme, they would do well to remember that which seems to have been forgotten since Dawn Primarolo's statement in 2004 (tinyurl.com/y4xg2n3k). Although the statement warned of impending retrospective legislation for remuneration schemes, her warning was couched in vague and broad terms. This not only created uncertainty for taxpayers, but also seemed to usher in a change of government policy and attitude towards retrospective taxation generally. This change was particularly apparent in the case of FA 2008, s 58 ('UK residents and foreign partnerships'), which was given indefinite retrospective effect despite objections from the CIOT and the ICAEW, and was heralded at the time as 'a retrospective clarification of the law' that was deemed 'fair, proportionate and in the public interest'.

Retrospection and differing aims

There is an important difference between a retrospective clarification to plug specific gaps in existing laws to ensure they operate as originally intended (such as the proposed Finance Bill 2020-21 changes to the hybrid mismatch rules of TIOPA 2010, Pt 6A, to take effect from 1 January 2017), and a retrospective clarification to address what HMRC believes the law should have said. Section 58 fell under the latter category, as does the loan charge. Even if the activity being targeted by a 'retrospective clarification' is considered an egregious tax avoidance scheme that runs contrary to the purpose and intent of the relevant legislation, the UK courts should still have a role to play in testing this point. If retrospective tax laws deny them this role, then the rule of law is potentially undermined, as the *Unison* case demonstrates (as to which see below).

> "If retrospective tax legislation is being considered, the government must give a clear, precise warning of the scheme it intends to target."

The principles set out by Peter Rees MP during the Finance Bill debates that eventually led to the enactment of FA 1978, s 31 to s 32 (known as the 'Rees rules') provide a helpful starting point for giving clear warnings. Broadly, these are as follows:

- The warning must be precise.
- The warning must be referred to a special committee to devise the precise legislative measures. In my view, this should be an independent tax law committee, drawn from members of professional bodies such as the CIOT and the ICAEW, which would be called upon to evaluate the adequacy of existing laws in tackling the avoidance scheme being targeted by the warning, and also whether the safeguards outlined in this article are met. The committee would also be given discretion to consider any information it deems relevant and appropriate, without political interference, before deciding whether the warning should be given legislative effect.
- If the committee is able to devise relevant measures with these safeguards in mind, they should be published immediately (in other words, in advance of the next Finance Bill) so those potentially affected will know what to expect.
- The measures must be enacted in the next Finance Bill without fail, and should be retroactive to the date on which the warning was made public.

2. Knowledge of a particular scheme

If retrospective tax legislation is being considered to stop a particular tax avoidance scheme, it must not penalise taxpayers who did not actually know that they were participating in such a scheme.

FA 2020, s 17 allows users of loan schemes entered into between 9 December 2010 and 5 April 2016 to escape the loan charge, but only if the individual's tax return for the relevant tax year contained 'reasonable disclosure' of the scheme's existence and HMRC had failed to take steps to recover the relevant tax for that year as at 6 April 2019.

> "The problem with this exception is that it requires taxpayers to operate in the territory of 'unknown unknowns'."

The problem with this exception is that it requires taxpayers to operate in the territory of 'unknown unknowns'. Reasonable disclosure necessarily requires taxpayers to know that they are participating in a tax avoidance scheme, otherwise how and why would it occur to them to seek advice on the matter, let alone disclose the scheme's existence? No amount of 'spotlighting' by HMRC is going to change that, unless taxpayers are lucky enough to have an adviser to alert them to HMRC's spotlights (tinyurl.com/y4nv42e3), or if they happen to come across them by random chance. Even then, many will have been drawn inadvertently into non-compliant umbrella company arrangements, often as a condition of their contract and with the promise of administrative convenience and avoiding IR35, and without having been given the full details of how those arrangements operate. This continues to be the case even if they ask sensible questions about the tax aspects of those arrangements, as shown by the 2020 decision in *White Collar Financial Ltd* (TC7934).

New clause 31, which was debated for inclusion in what became FA 2020, would have ensured that the loan charge would not apply to any taxpayers who did not knowingly participate in a DR scheme, but this was not put to the vote. In my view, this was a missed opportunity to make the charge strike the right balance between exchequer protection and fair treatment of taxpayers. Had this clause been included, the vast majority of taxpayers who used a post-9 December 2010 DR scheme would not have been subject to the charge, and would have had the opportunity to test whether their tax affairs could be resolved by the outcome of the ongoing litigation in *Stephen Hoey* (TC7292).

3. Consequential secondary liabilities

Retrospective taxation must not be used to establish back-door secondary liabilities.

In July 2017, the Supreme Court in *Rangers* held that contributions into an employee benefit trust (EBT) were subject to an earnings charge under ITEPA 2003, s 62, thus overturning the decisions in *Dextra Accessories Ltd & Others v MacDonald* [2005] STC 1111 and *Sempra Metals Ltd v HMRC* [2008] SSCD 1062, and the PAYE rules applied accordingly. What it *did not* do was impose a tax charge on the employees in respect of the loans being made to them by the EBT. As such, any earnings charge that may have been due under a DR scheme, whether pre or post-9 December 2010, should have been the employer's responsibility. However, since HMRC was unable to do this for practical reasons (often because the employer in question had disappeared or been wound up), the loan charge was introduced to collect the tax from the employee instead. In effect, this established a back-door secondary liability that HMRC would not otherwise have been entitled to pursue under pre-loan charge rules.

Secondary liabilities are, of course, nothing new. There are plenty of examples in the UK tax code (for example, CTA 2010, s 710 to s 712 relating to the recovery of unpaid corporation tax). However, the primary liabilities underpinning them are established in law and are imposed by reference to a particular accounting period or a single taxable event. They do not capture historic liabilities going back several years that HMRC (rightly or wrongly) believes should have been due. Even if an argument could be made to the effect that HMRC can legally recover unpaid PAYE liabilities from an employee on a secondary liability basis under ITEPA 2003, s 684(7A) – a point which is currently being tested in the *Hoey* litigation – the loan charge legislation would be rendered otiose if HMRC could simply rely on s 684(7A) to collect the employer's tax from the employee.

4. Time limits for raising discovery assessments

Retrospective taxation must not circumvent existing statutory time limits for raising discovery assessments.

With the exception of 'closed' years for which a 'reasonable disclosure' has been made, the loan charge is capable of applying for tax years from 2010-11 onwards. Ordinarily, save in cases of fraud, HMRC would be out of time for the tax years 2015-16 and earlier. By going back as far as 2010-11, the charge in effect overrides the six-year time limit within which HMRC can raise a discovery assessment for careless errors in tax returns. Ignoring these time limits not only undermines trust in the tax system, but also deprives taxpayers of any sense of finality, since the charge allows HMRC a second bite at the cherry if it has failed to abide by the statutory time limits.

5. Right of appeal

Retrospective taxation must have a right of appeal. The loan charge legislation confers no right of appeal against an assessment to such a tax liability.

The consequences of depriving people of the right to access the courts were summarised by Lord Reed in *R (oao Unison) v Lord Chancellor* [2017] UKSC 51:

> 'At the heart of the concept of the rule of law is the idea that society is governed by law ... courts exist in order to ensure that the laws made by parliament, and the common law created by the laws themselves, are applied and enforced. That role includes ensuring that the executive branch of government carries out its functions in accordance with the law. In order for courts to perform that role, people must in principle have unimpeded access to them. Without such access, laws are liable to become a dead letter, the work done by parliament may be rendered nugatory, and the democratic election of MPs may become a meaningless charade.'

Planning point

Those who entered a loan scheme between 9 December 2010 and 5 April 2016 can escape the loan charge if their tax return included a 'reasonable disclosure' of the scheme's existence and HMRC had not taken steps to recover the tax by 6 April 2019.

“*Unison* clearly shows that depriving taxpayers of access to the courts undermines the rule of law as envisaged by Lord Reed.”

Although the case did not specifically concern tax matters, *Unison* clearly shows that depriving taxpayers of access to the courts undermines the rule of law as envisaged by Lord Reed. This is exactly what has happened with the loan charge. By denying taxpayers access to them, the courts are unable to test whether the legislation is doing its job properly by deciding which DR schemes are effective and ineffective in light of parliament's intention. So the work that MPs put into making the legislation becomes pointless, while in the meantime HMRC is given free rein to impose a loan charge liability more or less whenever it sees fit.

What should happen next?

To address the harmful effects of the loan charge, and other retrospective tax laws generally, I would like to see the CIOT and other relevant professional bodies work with the Office of Tax Simplification, HMRC and the Treasury to introduce a set of statutory safeguards along the above lines at the earliest possible opportunity. To the extent the legislation fails to meet any of the safeguards, it should be declared incompatible with those safeguards and suspended until the legislation is made compliant. ●

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