

## PA HOLDINGS: A NEW THREAT TO EXTRACTION PLANNING?

The issue of extracting profits from private companies by dividends and/or salary has been raised by the decision of the Court of Appeal in PA Holdings.

The question which the Court was asked to decide was whether complicated arrangements put in place to turn executive bonuses into dividends were effective. In both the First-tier and Upper Tribunals, it was accepted that the payments arose from employment but the conclusion was that the tie-breaker in the old ICTA 1988 s20(2) would ensure that the dividend treatment overrode the employment income treatment. However, they also concluded that there was no equivalent tie-breaker for national insurance purposes.

The Court of Appeal unanimously rejected this interpretation and upheld HMRC's view that the dividends were earnings for both income tax and national insurance purposes. Lord Justice Moses took a highly moral line and some might argue has taken purposive interpretation of legislation to new extremes. In his view, the only way on which the matter could reasonably be viewed was: "to consider all the facts relevant to the receipt of the income. This requires the court not to be restricted to the legal form of the source of the payment but to focus on the character of the receipt in the hands of the recipient."

The payments had "arrived in the hands of the employees, as they were intended to, as bonuses". The inserted steps "which created the form of dividends...did not deprive the payments of their character as emoluments...and had no fiscal effect".

Furthermore, the Manthorpe Building Projects case considered many of the issues from PA Holdings. A manufacturing company paid amounts which were effectively bonuses to the husband and wife controlling shareholders and directors through a specially formed company. This company paid the amounts received on to the couple and the directors as dividends. The tribunal held that the payments were not effectively dividends and had to be treated as earnings, with the consequent income tax and national insurance treatments.

It is anticipated that the PA Holdings decision may be reviewed by the Supreme Court, given the importance to small companies. The concern is that where a director/shareholder is taking a small salary and large dividends, could HMRC use this case to

characterise some part of the dividend as employment income? Should we now advise owner/managers of an increased risk of HMRC attack on private company dividends, particularly if different classes of shares have been created?

If the Courts are prepared to take a substance over form approach to this extent, is there any need for a GAAR?

Writing this article in the week in which Jimmy Carr's tax planning arrangements have dominated the news headlines, it is perhaps ironic that clients who thought that their tax planning was conventional and low risk could face uncertainty and possible HMRC challenge to their extraction strategy as a result of these decisions.

### About the author ...

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### Valid Salary Sacrifice - Reed Employment plc v HMRC (UKFTT28(TC)) ("Reed")

#### Q What was the Reed case about?

A Reed was a First-tier Tribunal ("FTT") case which was decided in late January 2012 in favour of HMRC. It concerned the employment tax treatment of two travel allowance schemes covering up to 500,000 temporary workers across their period of operation.

It was contended by Reed that the schemes were operated in conjunction with valid salary sacrifice arrangements with the amount in dispute being a staggering £158 million!

Reed, as an employment agency, engaged workers under purported overarching employment contracts and implemented a travel allowance scheme to take advantage of the tax and NIC reliefs on travel and subsistence expenses which can apply for travel to temporary workplaces (i.e. client sites).

#### Q What did the FTT find?

A The main finding was that the salary sacrifice arrangements were ineffective and the FTT dismissed Reed's appeal.

This was due in the FTT's view to a number of reasons, including:-

- the existence of a facility whereby employees could opt in/opt out of the schemes at will was fatal - in line with HMRC's published guidance (see EIM 42767);
- pay wasn't actually reduced due to an automatic "add back" of the salary reduction;
- there was no reference to salary sacrifice in one of the two schemes such that the concept of giving up salary for the tax/NIC free benefit was not clear to employees;
- the benefit to the participating employees was minimal with a lack of reciprocity (something the FTT stated that salary sacrifice implies);
- there had been a lack of clear communication from Reed to participants and as such the FTT determined that employees could not have made an informed decision on whether to participate; and
- that the overarching employment contract did not exist and consequently that each work assignment for a client was performed at a separate permanent workplace rather than under a series of temporary workplaces under s.339 ITEPA 2003.

#### Q Why is this important?

A The decision is important in reiterating the key principles for valid salary sacrifice arrangements to exist.

While none of the particular reasons behind the decision of the FTT are surprising, the case emphasises some of those elements which are important to advise clients on in implementing salary sacrifice arrangements.

#### Q Does this mean that subsistence based salary sacrifice schemes are more likely to be challenged?

A No, provided a temporary workplace exists, the scheme is properly communicated, there is a valid sacrifice and a proper variation in Ts & Cs then the arrangements should be effective and with the potential to deliver meaningful value to employees and businesses.

#### Q Is Reed Employment appealing?

A Yes, the case has been referred to the Upper Tribunal. However, no hearing date has yet been set.

For further information on any of the above ...  
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