



The UK Supreme Court. © Getty/Dan Kitwood/Staff

Analysis

The Rangers FC case: payments to remuneration trust were themselves remuneration

Speed read

The *Rangers FC* case is about how to make a footballer's incentive sufficiently precarious that it can plausibly be offered on a tax free basis but, at the same time, sufficiently reliable that it has the desired incentive effect. The incentive took the form of funds paid to an employee benefit trust which granted loans to the footballer in connection with his employment. At the tax tribunal, the focus was on the validity of the trust and genuineness of the loans. These, it was held, had the effect of preventing the funds being taxed as remuneration unless and until they were paid absolutely to the footballer. However, as the case progressed to the Supreme Court, the focus switched to the nature of the payment to the trust as redirected earnings. The court noted that the law generally imposes income tax on remuneration paid as a reward for service in the employment regardless of the identity of the recipient (which may, therefore, be a third party). As a result, the court found in favour of HMRC. The result was to be expected, but the reasoning of the judgment is circular and it is questionable whether the law justifies the result.

The case, which started out life as *Murray Group Holdings v HMRC* [2012] UKFTT 692, has been finally determined by the Supreme Court as *RFC 2012 Plc (in liquidation) v Advocate General for Scotland* [2017] UKSC 45 (reported in *Tax Journal*, 7 July 2017). It concerns, in Lord Hodge's words giving the only judgment, the question of whether an employee's remuneration is taxable even though it is paid to a third party and the employee has no prior right to receive it himself or herself.

The facts

In 2001, a company in the Murray Group, which owned the Rangers Football Club, established an employee benefit trust (the EBT). Any company in the group which wished to reward one of its employees in what it thought was a tax-efficient way could make a payment to the EBT in respect of him or her. RFC 2012 Plc (RFC) made payments to the



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EBT in connection with both the hiring of footballers and the award of bonuses to senior executives. The bonuses were discretionary in the sense that the employees had no contractual right to them but they were paid as a reward for services. The employer company would then recommend to the trustee of the EBT that it should settle the payment on a sub-trust for the employee and other persons chosen by the employee and apply the assets of the sub-trust according to the employee's wishes. The trustee had a discretion whether or not to comply with these recommendations but invariably set up a sub-trust for the employee.

When RFC negotiated the recruitment of a footballer with either the footballer or his agent, a regular salary would be provided for in the employment agreement and further payments would be promised under a side letter, which provided for those payments to be made to the EBT in respect of the footballer. Those payments represented a further reward for services. This combination of a payroll payment and an EBT payment was intended to provide the footballer with an agreed amount of remuneration net of tax and was offered on a 'take it or leave it' basis. The footballer could not choose to receive his entire remuneration himself through payroll, presumably because this would have made the net of tax deal much more expensive to RFC (on its view at the time that the EBT payment would be tax free).

The footballer would also be told that he could request

a loan from the trustee out of the funds in his sub-trust and that it was unlikely that the loan would be recalled without his consent. The employee would be appointed protector of the sub-trust with the power to remove the trustee and change the beneficiaries. As protector of the sub-trust, the footballer would send a letter of wishes to the trustee setting out how he wished the trustee to exercise its discretionary powers and asking the trustee to apply the trust fund according to his wishes. The trustee almost invariably exercised its discretion to grant an unsecured loan equal to the full amount in the sub-trust. When a trustee started asking for security, it was replaced by a more compliant trustee. It appears that the powers of the protector could be exercised, albeit somewhat indirectly, to confer an absolute beneficial interest in the trust fund on the footballer himself.

The previous decisions

HMRC assessed RFC on the basis that the allocation of the payments to the sub-trusts or the loans by the sub-trusts to the footballers constituted taxable earnings of the footballers. RFC and other group companies appealed the assessments to the FTT. The majority of the FTT concentrated on the validity of the trust structure and the genuineness of the trustee's discretion. The footballer was not the beneficial owner of the trust fund and the loan was valid and legally recoverable. He had not, therefore, received any earnings while the funds remained in the sub-trust and all he had from the trustee was a loan. Accordingly, the appeal was allowed. In a dissenting judgment, Dr Heidi Poon decided that, applying a purposive construction of the law to a realistic view of the facts under the *Ramsay* principle, the facts should be more widely characterised than the legal form of the transaction. On that basis, the amounts lent to the employees should be regarded as their taxable earnings.

The UT could not detect any error of law in the approach of the majority of the FTT.

In the Court of Session, HMRC introduced a new argument (which, for convenience, might be described as the 'redirection principle') that a payment deriving from an employee's work qua employee is taxable as earnings even if the employee requests or agrees that it be directed to a third party. The Court of Session agreed and, accordingly, the payments to the EBT were held to constitute taxable earnings and PAYE should have been operated on them.

The Supreme Court's application of the law to the facts

In the Supreme Court, RFC argued that the redirection principle only applied in a case where the employee had a prior legal right to receive the payment himself or herself but directed that it be paid to the third party. In this case, the trust structure was offered to the employees on a 'take it or leave it' basis, so they did not have the option of receiving the payments themselves.

The taxation of earnings depends on the exertions of the employee, not the identity of the recipient

Lord Hodge said that, with one exception, there is nothing in the definition of 'earnings' in ITEPA 2003 s 62 which requires remuneration to be received by the employee. This is consistent with the definition of the 'taxable person' in ITEPA 2003 s 13 and the concept of a 'receipt' of earnings in ITEPA 2003 s 18. Remuneration constitutes taxable earnings if it derives from the employee's labour even where it is assigned, with the agreement or acquiescence of the employee, to a third party (*Smyth v Stretton* (1904) 5 TC 36; *Hadlee v CIR* [1993] AC 524). Effectively, Lord Hodge

affirmed the redirection principle on which the Court of Session's decision was founded. Consequently, as Lord Hodge put it, if a contract of employment provides that the employer will pay part of the employee's remuneration to Aunt Agatha, the payment constitutes the employee's taxable earnings, notwithstanding that the employee is not entitled to receive the payment himself or herself. He or she is only entitled to have the payment made to Aunt Agatha. The employee has no choice in the matter but, by entering into the contract on its terms, must be taken to have agreed to or acquiesced in the payment to Aunt Agatha.

The judgment reads well, the reasoning appears seamless and, these days, the result was to be expected. But does the law justify the result?

It is doubtful whether the proviso that the remuneration must be paid with the agreement or acquiescence of the employee adds much to the general principle that the taxation of earnings depends on the exertions of the employee, not the identity of the recipient. If an employer declares a discretionary bonus and stipulates that it will be paid to an EBT (with employees having no choice in the matter), the payment to the EBT is taxable as earnings, because either the employee can choose not to participate in the bonus arrangement or, if the employee decides to participate, he or she must be taken to have agreed to or acquiesced in the method of delivery. This is consistent with Lord Hodge's description of the central question as being whether an employee's remuneration is taxable even though it is paid to a third party and the employee has no prior right to receive it himself or herself.

The application of the redirection principle is not ousted, in a case where the third party recipient is a discretionary EBT, by the possibility that the trustee may not consent to the establishment of a sub-trust for the employee or to the grant of a loan. That possibility does not alter the nature of the payment to the trustee as a component of the footballer's remuneration. In applying a purposive interpretation of the taxing statute to a composite transaction viewed realistically, it is legitimate to have regard to the composite effect that the transaction is intended to produce; and, therefore, to disregard the possibility that, contrary to the intention and expectations of the parties, the scheme might not work as planned (*IRC v Scottish Provident Institution* [2004] 1 WLR 3172). The risk, which the footballers were prepared to take, that the trustee might not give effect to the side letters does not alter the nature of the payment as a component of their remuneration.

Exceptions where the legislation requires the recipient to be the employee or to belong to a restricted class

By way of exception to the general principle that the taxation of earnings does not depend on the identity of the recipient, ITEPA 2003 s 62(2)(b) includes in the definition of earnings benefits in the form of 'money's worth' only if the benefit is obtained by the employee. This gives statutory effect to the 'convertibility' principle.

Another exception to the general principle is the benefits code, which contains its own rules as to the identity of the recipient of the benefit. For instance, the residual benefit in Chapter 10 requires the benefit to be provided for an employee or a member of an employee's family or household.

Redirection principle does not apply to contingent funds

Where the employer's payment to the third party does not give the employee an immediate vested beneficial interest, but only a contingent interest, in the payment, the taxable earnings are not paid as remuneration until the occurrence of the contingency (*Edwards v Roberts* (1934) 19 TC 618; *Forde & McHugh Ltd v HMRC* [2014] UKSC 14). Accordingly, a salary sacrifice to a pension scheme should not be affected by the Supreme Court's decision in *RFC*, because there will normally be genuine contingencies (such as reaching retirement age or not being a bad leaver). In the case of contributions to registered pension schemes, there are in any case specific earnings exemptions. In the case of contributions to unapproved pension schemes, the principle in *Edwards v Roberts* may be trumped by the disguised remuneration regime.

The dividing line between an absolute fund and a contingent fund may be difficult to discern where the facts are close to that line, particularly as, following the *Scottish Provident* case, certain contingencies must be disregarded. The retirement funds in *Smyth v Stretton* and *Edwards v Roberts* were both contingent, yet the courts reached opposite conclusions. Ultimately, the question in each case must be: is the true nature of the payment to the third party that of earnings or of something that may mature into earnings?

Priority of the earnings charge

RFC argued that, having regard to the detailed provisions of the benefits code charging residual benefits in kind and beneficial loans to income tax as if they constituted earnings, there was no room for a general earnings charge on payments to an EBT. Indeed, there was a risk of double taxation. Lord Hodge disagreed. The tax code is not a seamless garment but more of a patchwork. Where a tax charge arises on general principle, the existence of more specific provisions which overlap to an extent does not necessarily supplant the general charge. In this case, as a matter of purposive statutory construction, it was the charges under the benefits code which had to yield to the prior general earnings charge to prevent double taxation.

The decision is circular: it starts with the assumption that there are earnings and then concludes that, because there are earnings, there is tax to pay

However, Lord Hodge does not seem to be saying that it is a statutory purpose of the patchwork to avoid double taxation. If it was, HMRC could invoke the benefits code if it was out of time to raise an earnings charge under the redirection principle. A specific statutory provision would surely be required to have that effect. Rather, he seems to be saying that if, on a proper analysis of the facts, an employee has directed a payment of his or her remuneration to a third party, the link between the employment and the money is severed once it is in the third party's hands. If the third party subsequently pays the money to the employee or makes a loan to the employee out of the money, that payment or loan is not employment related. The Court of Session was clearer on this point. It said that the remuneration redirected by the employee to the trustee would be held by the trustee as trust capital and that the situation was no different from an employee who uses part of his post-tax income to fund a trust for the benefit of his family.

This raises the question of whether the decision in *RFC* affects the application of the disguised remuneration (DR) regime (which is expected soon to include a charge on loans outstanding in 2019). The gateway to the DR regime applies where there is an arrangement for the provision of rewards or loans in connection with employment and the purpose of the regime is to tax those untaxed rewards or loans. However, if under the redirection principle a payment to an EBT loses its link with the employment, the DR regime should not apply to the money in the EBT's hands (or to any loan made out of it), even if no tax was paid on the payment to the EBT, because it was not appreciated at the time that the redirection principle applied. That conclusion, if correct, would be an own goal(!) for HMRC, as it is relying on DR to capture untaxed money currently sitting in legacy EBT sub-trusts.

PAYE: money placed unreservedly at the employee's disposal

Lord Hodge held that, where the redirection principle applies, PAYE has to be operated by the employer on the payment to the third party, as that is when the earnings are 'paid' (ITEPA 2003 s 686).

It was held in *Garforth v Newsmith Stainless Ltd* [1979] 1 WLR 409, that, where bonuses were credited to accounts with a company from which directors were free to draw, there was a 'payment' for PAYE purposes, because the money was placed unreservedly at the directors' disposal. From this, it was argued by *RFC* that a payment is made for PAYE purposes only if the money is paid to, or placed unreservedly at the disposal of, the employee. Lord Hodge roundly rejected that contention and, for good measure, held that *Sempra Metals Ltd v HMRC* [2008] STC (SCD) 1062 and *Dextra Accessories Ltd v Macdonald* [2002] STC (SCD) 413 were wrongly decided to the extent that they held that the trustee would have to exercise its discretion and appoint the funds absolutely to the employee before those funds could be unreservedly at the employee's disposal and, therefore, liable to PAYE.

The Supreme Court's decision

Lord Hodge dismissed *RFC*'s appeal on the grounds that:

- the payments to the EBT were a component of the footballers' remuneration for services rendered, regardless of the fact that they were made with the agreement or acquiescence of the footballers to a third party or that the footballers had no right to receive the payments themselves; and
- PAYE should have been operated by *RFC* on the payments when made to the EBT.

Critique of the decision

The judgment reads well, the reasoning appears seamless and, these days, the result was to be expected. But does the law justify the result?

The very first sentence of Lord Hodge's judgment contains a conjuring trick: 'This appeal concerns a tax avoidance scheme by which employers paid remuneration to their employees through [an EBT] ... [The] question is whether an employee's remuneration is taxable ... when it is paid to a third party in circumstances in which the employee had no prior right to receive it...'

Actually no, that is not the question: it begs the question, which is whether a payment made to T because of E's efforts is an emolument or earning of E when E has no entitlement to receive it. The right question is: is there remuneration to tax?

The judgment then goes on to prove that, if E has a right to be paid earnings and directs them to T, E remains taxable on them. Honestly, that was never in doubt.

But that principle applies only to cases where E has a right to be paid before T gets the money (see para 47 of the SC judgment) and this is not a case like that: the FTT found that E did not have a prior right to the money. The principle, on its own, does not, on the findings made by the FTT, lead to taxability of the payments to the EBT.

How happy should we be with the idea that something over 25,000 pages of detailed rules can be reduced to whether the court thinks something should be taxed?

How, then, does the court, wishing to impose tax in a case like this, get over the inconvenient absence of a right to be paid? The answer is to be found in para 64: 'The relevant provisions for the taxation of emoluments or earnings are drafted in deliberately wide terms to fit within the tax charge money paid as a reward for an employee's work.' Yes, and again, of course, but the money paid here was paid to T when E did not have a right to it and so cannot be reward for an employee's work at all: if it were, para 47 of the SC judgment would be wrong.

What then makes the payments to the EBT a reward for services? The answer is not just a matter of a realistic view of the facts (the decision of the FTT precludes that analysis). It is a matter of the purposive statutory construction to be adopted in applying the provisions which impose the charge to tax on emoluments and earnings, and require regard to be had to the composite effect of arrangements regardless of artificial contingencies.

But hang on a moment. Don't those provisions apply only once it has been decided that there are emoluments or earnings, not in deciding whether they exist?

Yes. So the decision is circular: it starts with the assumption that there are earnings and then concludes that, because there are earnings, there is tax to pay. Does that matter? After all, money was injected by an employer into a trust with the intention that it should reach the employee and it did. It is like putting water into a hosepipe: it doesn't matter how many hoops or delays you build in, the same water comes out the other end. Can we really expect such blatant, unattractive devices to succeed in avoiding tax?

Not today: when the water flows we must expect tax to be attracted no matter what the detailed rules seem to say: that is the general trend of the cases. But how happy should we be with the idea that something over 25,000 pages of detailed rules can be reduced to whether the court thinks something should be taxed. The rule of law is under threat in this country in so many ways and tax is an unattractive topic to use in its defence. But it would be nice to think that, at some point, we shall again be enamoured of the idea that rules matter. ■

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