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Principles and Practice”**

**Session 2: The Tax Treatment of Non-Financial Remuneration and Costs Associated with Working  
Comments of Colin Ben-Nathan, tax partner KPMG LLP and Chair of the Employment Taxes sub-  
Committee of the Chartered Institute of Taxation\***

Thank you and good afternoon everybody.

There is certainly a huge amount which could be said on the tax treatment of work-related costs and so inevitably I will only scratch the surface in the 15 minutes or so that I have available.

I want to consider firstly what we mean by a ‘benefit’ – at least in an employment taxes context – then to reflect on how work-related benefits are taxed, move on to ask whether the tax treatment should depend on how benefits are provided and, finally, to consider “where next?”.

So what do we mean by a work-related benefit? Well S201 of the Income Tax (Earnings and Pensions) Act 2003 tells us that, for the purposes of the benefits code, “benefit” means “a benefit or facility of any kind”. Certainly this is admirably brief but I have to say it doesn’t give a lot away!

What we might say though is that “benefit” covers a fair bit of ground...something helpful, advantageous, favourable etc . And indeed for things like vouchers, credit tokens, cars, vans and loans the traditional view has been that it is more about provision of the item than whether it is necessarily a ‘benefit’ per se. Although I have to say that the recent *Apollo Fuels* case is interesting

\*the views expressed here are personal to the speaker and do not necessarily reflect the views of either KPMG LLP or the Chartered Institute of Taxation

because it rejects this view and suggests that where there is a bargain at arm's length then there is no benefit. The case is being appealed by HMRC and so we will await the result with some interest. In any event, let's consider how the legislation currently deals with the proposition that, what we might refer to as "work-related" benefits, should not in fact be taxed on the employee.

There are essentially two approaches. Firstly, there are a whole series of exemptions that are codified in the 11 Chapters of Part 4 of ITEPA. These include benefits relating to things like the provision of work-related training, workplace parking, removal benefits, counselling and outplacement services, accommodation and supplies used in employment duties, a mobile phone... I could go on!

We used to have a limited exemption for computer equipment (previously S320 ITEPA). Whilst that was repealed my sense is that we don't tend to have too much of a problem here. I will return to this aspect later as regards the conditional exemption for workplace equipment where the employee's private use is "not significant".

These exemptions are all intended to be pretty focused and clear cut and represent specific situations where government has accepted that employer-originated spend on these types of work-related benefits should not be taxed. The point about their being clear-cut is, I think, very important because the employer needs to know the score in terms of the need otherwise to declare such benefits on its employees' Forms P11Ds, and indeed as regards the Class 1A National Insurance position.

And then we have the quite separate rules on deductibility, in Part 5 of ITEPA. Or at least they are quite separate at the moment, though as regards reimbursement of expenses it seems that we are going to see a move to an exemption system, further to the recent Office of Tax Simplification proposals and the related Government consultation. I will return to this point.

Anyway, in terms of deductibility we have, firstly, the general rule in S336 ITEPA for amounts which an employee is obliged to incur and where *“the amount is incurred wholly, exclusively and necessarily in the performance of the duties”*. And then we have the specific rules for things like travel and subsistence expenses, fees and subscriptions, directors’ indemnity insurance, business entertainment, and foreign travel and accommodation costs reimbursed by the employer.

In fact the general rule on deductibility was introduced some 160 years ago by William Gladstone as part of the Income Tax Act 1853. This Act also introduced a deduction for employee expenses necessarily incurred in *“keeping and maintaining a horse”* to enable the employee to perform his or her duties. In fact the deduction for keeping a horse lasted right up to 1998 when, as was said by HMRC at the time, the horse had more than done its job, was due a long-earned rest and so should be put out to pasture. Our tax rules do respond to change, though sometimes only very slowly!

But why are some employer costs subject to the rules on ‘deduction’ and others governed by those on ‘exemption’? Well, aside from the specific rules on deductibility that I have already mentioned on things like professional subscriptions and directors’ indemnity insurance, the general deductibility rule is of course very tightly drawn indeed - a deduction is only available if the expenses are incurred wholly, exclusively and necessarily in the performance of the employee’s duties. And so in addressing the tax treatment of the reimbursement of such general expenses by the employer, I think that successive governments have wanted to ensure that HMRC have the opportunity to challenge whether or not, in any given case, a deduction is in fact warranted. Hence the end result

that the employer is obliged to include all such general reimbursements on Forms P11D, and the individual then needs to claim relief. Unless, of course, a dispensation is agreed with HMRC to relieve the employer of this obligation in circumstances where HMRC is satisfied that no tax is in fact due. Whereas in terms of exemptions these are targeted at particular situations, e.g. around removal benefits, where it is accepted that provision of such work-related benefits, or expenses reimbursed to employees by the employer to cover such benefits, should not be taxed. So exemption is then appropriate and a “tax and relieve” approach is unnecessary. I can see the logic here.

So what about the current proposals to move from deduction to exemption for reimbursed expenses? Well I can certainly see the attraction of this for deductions covered by the specific rules (for example, travel, business entertainment, directors’ indemnity insurance or fees and subscriptions). Here there would be a clear saving of administrative effort for employers and HMRC alike on Forms P11D dispensations. However, whether this is going to work effectively for spend covered by the “*wholly, exclusively and necessarily*” rule I am not so sure. Are employers really going to be happy having to make a call on what qualifies as tax exempt and what does not and so what needs to go on the employees’ Forms P11D? Remember that presently everything goes on the Form P11D unless agreed otherwise with HMRC, which represents a safety net for the employer. And so what if, despite guidance from HMRC, employers make a mistake and misclassify something as exempt when it is in fact taxable? It seems to me that employers will be rather more exposed. That said, I am sure that HMRC will be considering this point as part of the consultation process.

And certainly it can be a fine line to tread as regards what is deductible and what is not, both for reimbursed and unreimbursed expenses. So in Elwood v Utitz a director was allowed a deduction for visits on business to London from Northern Ireland for the cost of subscriptions to a London club which allowed him to access to cheaper accommodation. But in Brown v Bullock a bank manager

was refused a deduction for his club subscription which he said was geared to enabling him to make social contacts. This is by no means an easy one to call.

Sometimes, of course, tricky cases have triggered a change in the law on work-related benefits. Kerr v Brown is an example. Two fire officers in Northern Ireland were assessed to a benefit on home to fire station travel for a car owned by the fire service, albeit they had a de-mountable blue flashing light which they used on such occasions. HMRC's challenge, interestingly, was not under the car benefit rules but under S201 ITEPA and the residual charge. Suffice to say that HMRC won but thankfully the law was changed and we now have the exemption in S248A.

In Rendell v Went it was held that the motive of the employer is to a large degree irrelevant. Here the company took over and paid for the legal defence of a director against a dangerous driving charge. It did so because it was concerned that the director would be sent to jail. However, the House of Lords held that there was no doubt that the employer's assistance was of material benefit to the director. The fact that the company's sole motive was to protect itself was of no consequence. Whether of course that is the way the law *should* be framed is another matter.

And contrast the cases of Daly v Commissioners of the Inland Revenue and Nagley v Spilsbury. In the first case board and lodging was provided to an employee but there was no money's worth and so no charge to tax. In the second two soldiers were allocated to civilian billets and were paid a lodging allowance. There it was held that the allowance was taxable, and that no deduction was justified under the wholly, exclusively and necessarily rule. Cash allowances are definitely problematic it has to be said – at least as things stand presently. The same point arises for meal allowances and late night working, as demonstrated by Sanderson v Durbridge.

There are a few cases which bring out exceptional circumstances on work-related benefits, and Hochstrasser v Mayes, which concerned a relocation and the employer making good a loss on the sale of an employee's home, is one of these. I am not going to dwell on Hochstrasser other than to say that the message is around the importance of ascertaining whether a benefit arises further to the employment or, as was held in this rather special case, some separate matter.

And equally there are cases which emphasise the courts' view on the very wide application of the "wholly and exclusively" element of the general deduction rule. In this respect Mallileu v Drummond, albeit concerned with a self-employed barrister, set a very high bar in terms of deductibility of the cost of clothes for work. In particular, that for all but clothes which are not part of an employee's everyday wardrobe then the employee's conscious – or unconscious – objective of clothing themselves for the purposes of warmth and decency will be enough to rule out of a deduction. Albeit that deductions for protective clothing and uniforms are permitted. Whether the rules *should* be so strict is, of course, another matter.

And I wonder if, in practice, they always are. Take, for example, business entertaining costs. I am sure we are all aware of the special rules preventing an employee obtaining a deduction for the expenses of entertaining customers unless certain conditions are satisfied; in particular, a disallowance in computing the employer's profits. But let's suppose these conditions are satisfied and we are back to considering whether, in circumstances of a reimbursed expense for a lunch with a customer, a deduction is possible when business matters are discussed. The answer, of course, is that it is. And, indeed, this is a pragmatic and sensible result ... although if one was a purist then, in considering the "wholly and exclusively" test, one might ask whether for the employee specific element of the cost of the lunch this was incidental, or intrinsic, to the employee's everyday existence. I hasten to add that I do not propose any change in practice; I just think it is interesting

that there is a welcome degree of pragmatism in interpreting “wholly and exclusively” in these particular circumstances.

And what about laptops, i-pods, Blackberrys and other similar IT kit typically provided by employers? Despite the repeal of S320 ITEPA, which provided for an exemption for computer equipment, and to which I referred earlier, we still have the broader exemption at S316 for accommodation and supplies made available by an employer so that an employee can do the job. This is provided that any private use is “not significant”. Personally I think this exemption works pretty well in practice, though the formulation around insignificant private use is clearly a very different approach from the “all or nothing”, “wholly, exclusively and necessarily” limitation for employee deductions.

So what about how benefits are provided and whether this should matter in determining how they are taxed? My view is that this essentially comes down to balancing flexibility and simplicity against the cost to the Exchequer. And I think the tax rules have been designed – or have evolved – very much with this in mind.

So consider work-related training as an example. There is an exemption at S250 ITEPA where the training is provided by the employer, or where employee training expenses are reimbursed. But a deduction only applies in very limited circumstances where an employee incurs unreimbursed training costs of their own, the favourable judgement in the Banerjee case being very much the exception. The rationale here is presumably that the Exchequer cost would simply be too great to allow everybody to do their own thing on training and to claim a deduction for it. With the thought being that if the employer decides to fund the cost then that is reassurance that the money is indeed being spent on, as it were, the “right sort of training”.

But what if there is a salary sacrifice whereby the employer pays a reduced salary and instead provides the particular benefit to the employee (or reimburses the particular expense)? And where the employee would not get a deduction for the expense, but where provision of the benefit by the employer is tax exempt. Work-related training is of course a good example. Other examples include workplace parking, mobile phones and, on a broader front, childcare vouchers. Should salary sacrifice be viewed as problematic or abusive because a disallowed deduction is being transformed into a tax exempt benefit? Or conversely does the possibility of salary sacrifice mean that a deduction should be allowed for the unreimbursed employee expense in the first place? My answer is, in general, no on both counts. If, all things considered, the policy is that an exemption is appropriate then I do not think that policy should be displaced by the possibility of salary sacrifice. But equally I do not see the possibility of salary sacrifice as a reason for allowing a deduction for the employee where none is presently available. I would add that if, exceptionally, there is considered to be a risk to the Exchequer yield then, clearly, anti-avoidance legislation could be enacted to preserve the *status quo*. And indeed a recent example of this is subsidised meals provided on an employer's premises and the change made in Finance Act 2010.

I do, however, have a particular suggestion to make on National Insurance. This is that I don't see why employer Class 1A NIC on benefits could not be replaced by employer-only Class 1 NIC. Both have essentially the same effect and it would seem to me logical and relatively straightforward to make this simplification.

So where does all this leave us?

I think that first of all we need to properly understand our current approach to work-related benefits. And the history of the legislation and the case law is important here to appreciate how we have arrived at where we are, and how the rules have been applied in practice. We then have to



decide whether, in the C21st, the policy rationale remains valid. The excellent work done by the Office of Tax Simplification and the recent Call for Evidence on Remuneration Practices will, I am sure, greatly assist with this.

Returning briefly though to the “wholly, exclusively and necessarily” rule, there are alternative approaches that might be possible. Indeed the CIOT published a paper a few years back which discusses this, for self-employment as well as employment. It looked at the argument for moving to a more generous approach whereby expenses are allowed if they are (i) reasonable in the circumstances and (ii) if they would not have been incurred by the individual “but for” the needs of the business or the employment. This would be coupled with a rule to allow the individual to dissect and apportion any mixed-purpose expenditure. Altogether this would indeed represent a material departure from the current “all or nothing” approach. It is arguably more equitable to the employee, though I suspect it would inevitably come at a cost in terms of tax yield to the Treasury.

In conclusion, I think that, all things considered, the building blocks of a fairly broad definition of “benefit”, specific exemptions and a reasonably high bar for employee deductions feels about right to me. And I do wonder just a little bit about how moving the “wholly, exclusively and necessarily test” for work-related expenses from a rule on deduction to one around exemption is going to work in practice. But that doesn’t mean we shouldn’t reflect carefully on whether some further, specific exemptions and deductions are needed, whether there is a case for apportionment and whether the National Insurance position can’t be simplified.

Thank you very much.