

Is the employee benefit trust ('EBT') dead?

22 DECEMBER 2010

CATEGORY:
ARTICLE

On 9 December 2010, Finance Bill 2011 draft clauses were published, and included proposals intended 'to tackle arrangements involving trusts or other vehicles used to reward employees which seek to avoid or defer the payment of income tax or National Insurance Contributions ('NICs')'. The legislation will have a significant impact on existing EBTs and will be a disincentive for establishing new EBTs.

From 6 April 2011, where a trustee earmarks, pays, transfers or makes available a sum or asset for a current, former or prospective employee which is, in essence, a means of providing reward or recognition in connection with employment, that step will be subject to income tax (under the PAYE system) and NICs.

Anti-forestalling provisions operate from 9 December 2010. However, their scope is limited. It is unclear whether this is deliberate or through drafting error. There may therefore be opportunities for employers to make further additions to EBTs and for trustees to allocate funds to sub funds before 6 April 2011 to defer any income tax liability until such time as the employee receives a benefit from the EBT. There may also be a final opportunity to transfer assets to the members of an ex-employee's family free of income tax before 6 April 2011.

Draft legislation

It is important to remember that the draft legislation is only in draft. Taxpayers are being given the opportunity to review and comment on it by 9 February 2011, before the Budget on 23 March and publication of the Finance Bill on 31 March. While we have already asked HMRC to clarify several points of uncertainty in the draft legislation, we remain relatively sceptical as to the extent to which responses to the draft legislation will result in significant change. That being said, there is a remote chance that the pre-6 April 2011 planning opportunities we have identified below, which stem from the limited scope of the anti-forestalling provisions, could be restricted with retrospective effect.

Existing EBTs

Adding further funds to an EBT

The draft legislation suggests that the addition of funds to an EBT will not be subject to income tax and NICs until such funds are 'earmarked (however informally)' for an employee from 6 April 2011. However, the position is not entirely clear and the very addition of funds from 6 April 2011 could potentially constitute informal earmarking. We have requested clarity on this issue from HMRC.

Funds not yet allocated to a sub fund

Sums 'earmarked (however informally)' for an employee from 6 April 2011 will be subject to income tax and NICs. From 6 April 2011 it is therefore important that no further allocation, however notional or informal, potentially including discussions between the trustee and the employer, is undertaken so that unallocated funds cannot be said to have been 'earmarked'.

Funds already allocated to sub funds

The draft legislation requires that a 'step' be taken to earmark, pay, transfer or make available a sum or asset to trigger a tax charge. Sums already allocated to sub funds should therefore be grandfathered, until such time as a further step is taken, unless it can be said that failing to revoke a sub fund appointment constitutes the taking of the 'step' of making the sub fund available to an employee, which would create a tax charge on 6 April 2011. This requires a very wide interpretation of the legislation which is relatively unlikely. Nevertheless, we have asked for clarity on this point from HMRC.

Outstanding loans

Outstanding loans of money or assets to employees which remain outstanding as at 6 April 2011 should also remain outside the scope of income tax and NICs. However, again the point is not entirely clear and we have sought clarity from HMRC in this regard.

Traps to avoid

New loans

From 6 April 2011, loans from existing EBTs provided to an employee, or a person chosen by the employee, will be subject to income tax and NICs. Anti-forestalling provisions effectively catch loans made after 9 December 2010 but before 6 April 2011 which are not repaid before 6 April 2012.

Distributions to ex-employees who have moved abroad

In the past employees have attempted to step outside the employment taxation provisions by relocating abroad and then receiving distributions free of income tax. The new rules have the effect that any part of a distribution which is 'for' duties performed within the UK will remain subject to income tax and NICs.

Planning opportunities before 6 April 2011

Adding further funds to an EBT

Given that the anti-forestalling provisions only seem to apply where a trustee 'pays a sum of money to a relevant person' or 'makes available a sum of money or asset for use as security for a loan' there may be an opportunity for employers to add further funds to an EBT before 6 April 2011 to provide for a deferment of an employee's income tax liability until such time as the employee receives a benefit from the EBT.

Funds not yet allocated to a sub fund

Again, given the limited scope of the anti-forestalling provisions there may be an opportunity for trustees to allocate assets to sub funds before 6 April 2011.

Distributions to ex-employees' families

Whereas previously trustees of an EBT could potentially make tax free distributions to the members of an ex-employee's family, provided that the distribution was not indirectly for the ex-employee's benefit, the new rules include provisions taxing any distributions to an employee, ex-employee or a person chosen by them. However, the anti-forestalling provisions do not extend to where a trustee 'transfers the property in an asset to a relevant person.' There may therefore be scope for trustees to acquire assets and distribute those assets to members of an ex-employee's family before 6 April 2011 free of income tax and NICs. Specific advice should be sought.

Existing loans

If there is scope for trustees to distribute assets to members of an ex-employee's family before 6 April 2011 free of income tax and NICs, it may also be possible to distribute the benefit of existing loans to members of an ex-employee's family, since these constitute a trust asset. Again, specific advice should be sought.

New loans

Because the anti-forestalling provisions do not extend to where a trustee 'transfers the property in an asset to a relevant person' it may be possible for a trustee to acquire assets and lend those assets to beneficiaries before 6 April 2011 free of income tax and NICs, just as cash could be lent under the old rules. Again, specific advice should be sought.

Furthermore, the anti-forestalling provisions only catch loans made after 9 December 2010 which are not repaid before 6 April 2012. Therefore, employees with short term funding requirements may look to the trustees of an EBT to make loans which will be repaid before 6 April 2012 which should not result in any tax charge.

Distributions to employees

In light of the new draft legislation many employees may consider requesting distributions of their entire sub funds. However, from a cash flow perspective they may be advised to request a loan before 6 April 2011, since this will not trigger a tax charge until 6 April 2012. On 6 April 2012 the trustee could write off the loan and trigger the tax charge. This should defer the tax charge for at least one year compared to an outright distribution before 6 April 2011.

Employee share ownership plan trusts (ESOPs)

One use of EBTs is as a warehouse for shares to be used to satisfy option awards granted by employers. Typically, an employer will enter into an agreement (a 'linking agreement') with the trustees under which the trustees agree that, upon being notified by the employer that it has granted a share option, the trustee will reserve sufficient shares held by them to enable the option to be satisfied if and when exercised.

The effect of the draft legislation appears to be that the reservation of a specific number of shares to satisfy an option granted to a particular employee will create an immediate tax charge on the value of the shares (by contrast to the existing position where no tax is payable until the option is exercised or released). There are a number of exclusions for certain approved schemes and arrangements (including approved SIP, CSOP and EMI schemes and SAYE option schemes and registered pension schemes) but no similar relief is provided if the option is unapproved.

Such reservations and linking agreements are entered into not for tax avoidance purposes (after all, the exercise of the securities option will be fully taxable) but for commercial reasons. The employer wants to have certainty that options can be satisfied. It also wants control over who receives options, rather than leaving it up to the trustees' discretion.

We are currently putting representations to HMRC to amend the draft legislation to provide an exclusion for the reservation of securities where there is a related acquisition of an employment-related securities option.

Employer financed retirement benefit schemes ('EFRBS')

The draft legislation applies to EFRBS in the same way.

New EBTs

Except in very limited circumstances, the new rules signify the death of EBTs from 6 April 2011 if they are not ESOPs. Sums earmarked for employees will now be subject to income tax and NICs, preventing the deferral of taxation and therefore significantly impacting upon the attractiveness of new EBTs.

However, some wealthy UK domiciled employees may still look to EBTs as part of their wider planning. An employer could add funds, albeit upon which income tax and NICs must be paid up front, to an EBT which is outside the employee's inheritance tax net, without triggering an immediate inheritance tax charge at 20%, and which should offer a tax free roll up of funds until such time as the trustee earmarks, pays, transfers or makes available a sum to the employee.

Authors

Philip Munro

PARTNER | LONDON

Private client and tax

 +44 20 7597 6515

 philip.munro@withersworldwide.com

Paul McGrath

PARTNER | LONDON

Corporate

 +44 20 7597 6156

 paul.mcgrath@withersworldwide.com

Christopher Groves

PARTNER | LONDON

Private client and tax

 +44 20 7597 6127

 christopher.groves@withersworldwide.com

Justine Markovitz

CHAIRPERSON | GENEVA

Private client and tax

 +41 22 593 7711

 justine.markovitz@withersworldwide.com