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The Employee Benefit Trust ('EBT'): Down but not out?

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In our briefing note, dated 22 December 2010 discussed the draft Finance Bill 2011 clauses introduced on 9 December 2010 and posed the question, is the EBT dead? The draft clauses proposed the introduction of an income tax charge (under the PAYE system) and National Insurance Contributions ('**NICs**') where the trustee of an EBT 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. The majority of the new provisions will apply from 6 April 2011 with limited anti-forestalling provisions, operating from 9 December 2010.

The draft legislation was very broad in scope, on the face of it catching many situations, which were entirely commercial in nature and not at all intended to avoid or defer tax. In other respects, the intention of some of the draft clauses was unclear. We, along with many other professional firms and organisations, have sought clarity from HMRC on many points and they have responded with the publication on 21 February 2011 of some Frequently Asked Questions ('**FAQs**').

In short, HMRC recognised the need to amend the draft legislation to restrict its scope in some circumstances and clarify its meaning in others. The remainder of this note addresses how the FAQs deal with the questions raised in our 22 December 2010 briefing note.

Taxation of existing sub-funds

Under the original draft legislation there was a concern that income or gains arising to funds that had already been earmarked would be will be an additional earmarking. The draft legislation will now be amended to ensure that the receipt by an EBT of income or gains arising on funds or assets, which have already been earmarked, will not in and of itself amount to an additional earmarking. This will allow funds that are already earmarked to continue gross up tax-free.

Adding further funds to an EBT

It was unclear from the draft clauses whether merely adding funds to an EBT could create an income tax and NIC charge. The FAQs clarify the position by giving HMRC's view that merely adding funds or assets into an EBT will not give rise to a charge unless and until there is some further 'earmarking' of the trust's assets in relation to specified employees.

Funds already allocated to sub-funds

The draft clauses do not themselves make it clear whether failing to take steps to revoke an existing sub-fund appointment would constitute the taking of a 'step' of making the sub-fund available to an employee, thereby triggering a tax charge. HMRC's FAQ on this point is ambiguous but the implication is that mere inactivity on the part of the trustee will not trigger a tax charge: some further act of 'earmarking' would be needed.

Outstanding loans

The draft clauses were not clear as to whether loans made available to employees before 9 December 2010, which remain outstanding as at 6 April 2011, should remain outside the scope of income tax and NICs. The FAQs clarify that they will be outside the scope of the new rules, unless there is a drawdown of a loan on or after 9 December 2010.

Employee Share Ownership Plan Trusts (ESOPs)

In our briefing note of 22 December 2010, we highlighted a problem with many common ESOP arrangements, where the trustees of the ESOP set aside a number of shares in order to satisfy future exercises of share options granted by an employer. These arrangements can trigger a tax charge under the new rules (by contrast to a specific exemption where the option is granted by the ESOP trustees themselves, rather than the company).

The FAQs addressed this point in part by announcing that amendments would be introduced to the draft legislation to provide a further exemption. However, the criteria for qualifying for the exemption are restrictive. Unsurprisingly, one criterion is that the deferral or avoidance of tax must not be the main purpose or one of the main purposes of the arrangement. The criterion which may be the most difficult to fulfil in many instances is that the award must 'vest' no later than five years from the date of grant. Many share option plans and long term incentive plans ('**LTIPs'**) have a ten-year life span on awards. That said, it is not clear what HMRC mean by 'vesting' in this context: with a share option in particular, there is commonly a distinction between the vesting of the option (ie the moment at which the number of shares which is subject to the option is finalised) and exercise (the moment at which the employee pays the exercise price and acquires the underlying shares).

Interaction with the FSA's Remuneration Code

Many financial services businesses are currently implementing the requirements of the FSA's Remuneration Code. The Code obliges some employers and encourages others to defer proportion of variable cash bonuses and to award some bonuses in the form of shares or share-like instruments. Many of these arrangements could be caught by the draft Finance Bill 2011 clauses, even without the use of an EBT.

The FAQs recognise that this was an unintended consequence of the new rules and announce that amendments will be introduced to exempt deferred rewards which satisfy similar qualifications as for share based awards held in ESOPs, discussed above.

Conclusion

The clarifications and announcements of amendments are to be welcomed, although, as always, the legislation itself, when finalised, will need to be examined carefully to ensure arrangements do not inadvertently fall foul of the new rules.

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