

Employee benefits trusts & employer funded retirement benefits schemes

We are pleased to announce the launch of Employee Benefit Trusts (EBTs) and Employee Funded Retirement Benefit Schemes (EFRBS) in conjunction with Speechly Bircham.

There can be little doubt that the profile of EBTs and EFRBS has been raised considerably by the introduction of the 50% income tax rate and further still by the restriction on pension's tax relief for those earning over £130,000. The ability to defer the 50% income tax charge today to a potentially lower rate in the future remains an attractive proposition to many investors.

Introduction

EBTs have been with us for a number of years, although they have received a mixed press and attention from Her Majesty's Revenue & Customs (HMRC). Nevertheless these trusts continue to be legitimate remuneration and tax planning structures that many corporate clients will wish to explore further with you.

EFRBS are effectively a reincarnation of Funded Unapproved Retirement Benefit Schemes (FURBS) and, although subject to some comment from HMRC, do, where structured appropriately, represent genuine alternative remuneration options.

When you consider the increases in income tax and the restriction of personal income tax allowances for those earning over £100,000, you can see why EBTs and EFRBS, which mitigate or defer the effect of increased tax liabilities, are potentially attractive.

Principal uses

There are significant advantages to the establishment of an EBT/EFRBS, not least where an employer is looking to recruit a new employee who the company may wish to retain for the longer term. By establishing the EBT and making the new employee/executive a beneficiary of the trust, the employer will be able to offer the beneficiary a significant incentive to remain loyal to their new employer.

The principal uses of employee trusts are as follows:

1. To provide a tax-efficient bonus alternative for key employees

Payments made into an EBT/EFRBS are not, at that point, subject to income tax or National Insurance – the employee thus, via the trustees, receives gross funds for investment in the trust and benefits from a deferral of liability to income tax and National Insurance until funds are distributed in the future (when the employee's tax rate may be lower).

However, the company will not receive corporation tax relief on the payments (unlike payments to pensions or on salary/bonus payments). This loss of relief for the company can be either dismissed on the basis that the monies are part of senior executive/director's remuneration, or the company could offer a choice to employees – for example, the option of 100% bonus, or 85%-90% payment into an EBT or EFRBS. The discount aids the company's negative cash flow and it should be remembered that ultimately corporation tax relief will be available once a taxable distribution is made.

2. To provide deferred remuneration

An employer may wish to make provision for future remuneration for their employees, sometimes referred to as 'golden handcuffs'. An EBT can form the basis of the structure to provide identifiable pots of money for future benefits. Effectively, employees will have more than just a promise of future benefits, even though no vested rights will be necessarily granted at outset. There is, of course, nothing to preclude the terms of the trust establishing contingent rights, for example, on completion of

a specified number of years of service, or linked to the performance of the individual, profitability of the company or share price, etc.

3. To facilitate share acquisition by employees

An employee trust combined with a share incentive or a share option scheme (whether approved or unapproved) would provide tax planning opportunities, subject to appropriate conditions and constraints for the transfer of shares to employees, e.g. on the employee exercising his/her option, or simply at the discretion of the trustees and subject to the terms of the trust. The trust can acquire new shares on issue by the company, or can buy shares from other shareholders, effectively holding them until the need for distribution to the employees. Shares can then be transferred to the employees at a price which is at a discount to the market value of the shares when acquired. In other words, the employee trust acts as a form of warehouse for the shares of a company.

4. To protect against unwanted takeover, bid or purchase

An EBT can provide a way of defending against unwelcome takeover bids by spreading share ownership more widely. Trustees of an employee trust must act in the best interest of the trust beneficiaries and this may well be to reject a hostile takeover bid. Company Law, however, restricts the extent to which this may be a valid motivation for establishing a trust.

When an EBT/EFRBS is unlikely to be of benefit;

- **Close companies are unlikely to use EBTs/EFRBS**

A close company is a UK company controlled by five or fewer participators, ie a person with a shareholding in the company's capital or income in the company, or having the right to acquire a shareholding or interest. This is because a contribution by a close company will be treated as a transfer of value for the purposes of Inheritance Tax, ie a Chargeable Lifetime Transfer by the shareholders. The only way to avoid a Chargeable Lifetime Transfer arising (with the exception of an in specie transfer of an asset that would otherwise be exempt, i.e. benefiting from Business Property or Agricultural Property Relief) is that the shareholders are excluded from any benefit, including any person connected with them – spouse, children, etc, plus any person entitled to 5% or more of the share capital. This exclusion from benefit includes any ability for the participators, or anyone connected to him or her, taking loans from the EBT or EFRBS.

It is, therefore, unlikely that a shareholder of a close company would set up an EBT as it would have to be to the exclusion of himself or his family. By definition, they are equally as unlikely to establish an EFRBS either. The only exception to this is if the shareholders were prepared to exclude themselves and wish to establish an EBT or EFRBS for the benefit of key employees.

Appendix 1 – Q&A

What is an EBT?

An EBT is a discretionary trust established by a company (or an LLP) for the benefit of its employees and their immediate families. An EBT can be established onshore, but typically it is set up offshore to avoid UK Capital Gains Tax (CGT) arising on investment returns and to limit the current year income tax liability to UK source income.

What are EBTs used for?

EBTs are used to provide benefits for employees – often in the context of share based incentive plans but also for cash based deferred remuneration schemes. In the case of the latter, they allow employees the opportunity to defer receipt and to benefit from gross roll up of the investment return in the meantime (with the benefit of funds drawn down when it is required by the employee) and to lock into anticipated lower income tax rates in future.

Who are the beneficiaries of an EBT?

The beneficiaries of an EBT will typically include all current, former and future employees of the employer company or group, as well as their dependents. This is necessary to ensure that the EBT is not subject to the 10 yearly and exit Inheritance Tax (IHT) charges that arise on other discretionary trusts. Benefits can, however, be targeted at specific employees only.

Close companies

Particular care must be taken with companies that are “close” ie they are controlled by five or fewer participators (shareholders) or by the board of directors (or their respective family members and associates).

As a general rule, unless such participators and associates are excluded from benefiting (other than in limited circumstances only) there will be an immediate 20% IHT charge on the contribution of funds in excess of the nil rate band by the close company to the EBT. A transfer of value would also be treated as arising on the withdrawal of benefits from the EBT.

This is an area where HMRC have been active recently and therefore EBTs may not be appropriate for owner managed businesses which are close companies and are simply looking to shelter surplus shareholders funds.

The EBT trustee and operation of the trust

The EBT trustee is independent of the employer company. The EBT trustee will decide to which employee beneficiary or beneficiaries the assets of the trust should be allocated. In making such decisions, the EBT trustee may under the terms of the trust deed, be required to consider the recommendations of the employer company. As a matter of practice, it will do so in any event. Allocations to sub trusts of the EBT established for the benefit of a specific employee and his family will generally not give rise to a tax charge at that stage. Assets held within the sub trust will continue to be held and controlled by the EBT trustee but will be applied only for the benefit of the nominated beneficiaries. In deciding how to apply such assets, the EBT trustee will consider the wishes of the named beneficiary.

Loans from an EBT – Income Tax

A common proposal is for funds placed in sub trusts of an EBT to be loaned out to the sub trust beneficiary. Such loans will be treated as provided by reason of employment and will be subject to income tax on the notional interest foregone, to the extent that interest is charged on the loan at a lower rate than HMRC's official rate of interest.

While long term loan arrangements are presented as a method of "postponing" tax payable on sums received while enjoying the benefit of the sums lent, HMRC will look closely at any loan arrangement to see whether the circumstances of the loan are such that there was no intention on the parties that the loan should ever be repaid. If HMRC consider that the parties intended that the loan should not be repaid, they will treat the loan as a distribution subject to income tax and NIC in the year in which it is made.

It was widely anticipated that HMRC would introduce legislation to counteract long term loan arrangements in the December 2009 Pre-Budget Report, but this did not happen. Risks here can, in any event, be reduced if the EBT trustee is properly advised – the trustee, for example, should satisfy itself prior to making the loan that the beneficiary will be able to repay the loan in the future.

Loans from an EBT – IHT

Funds held within an EBT (including a sub trust) will not usually form part of a beneficiary's estate on death for IHT purposes. Furthermore, if a loan is made by the EBT, the loan may well be accepted as a debt of the estate on the death of the beneficiary for IHT purposes. Of course, if there is no genuine intention that the loan should ever be repaid, then a claim for allowable deductions may be disputed.

What is the tax position of a beneficiary of an EBT?

Distributions from an EBT are generally treated as taxable and will be subject to income tax and National Insurance Contributions (NICs) in the normal way at the rates prevailing at the time of the receipt of the benefits. The employer company should ensure that PAYE is properly paid on such benefits and that suitable arrangements are agreed with the EBT trustee to collect such tax and account for it to HMRC, as the default position will be that the employer company will be responsible for the unpaid PAYE and NIC.

Benefits provided to beneficiaries, other than the employee, are generally also subject to income tax.

What is the tax position of the employer company?

Over the last 10 years HMRC have, through case law and statute, been seeking to counteract perceived EBT tax avoidance by aligning the tax position of the employer and the employee.

If the employee receives salary or a bonus, the employer pays NIC and the employee pays income tax and NIC. In return, the employer is given a corporation tax deduction for the salary or bonus (inclusive of the employer NIC).

Where a payment is made into an EBT and so effectively defers the income tax and NIC, there is no longer an immediate tax deduction for the employer company. In practice, the deduction is only available at the time that the employee receives a benefit and income tax and NIC becomes payable. Loans to employees do not give rise to a corporation tax deduction on the amounts lent. Similarly, allocation to a sub trust does not crystallise the corporation tax deduction for the employer company. A number of schemes have been touted which purport to make available a corporation tax deduction at the time that the funds are contributed to the EBT. These are highly aggressive and HMRC have announced that they are both aware of such schemes and are actively challenging them.

The impact of the deferral of the corporation tax deduction from the employer perspective should not be overlooked. For employer companies which do not pay corporation tax the issue is not a material one – which may be a relevant factor in the financial services and football sectors (for example). In practice, however, the employer company may want to insulate itself from the cash flow cost of the loss of the corporation tax deduction by only contributing a percentage of the bonus to the EBT.

The balance is then picked up when the corporation tax deduction is received, or is paid out directly to the employee.

Sub Trusts

It is common for an EBT to contain a large number of beneficiaries. The impact on the administration of the beneficiaries' funds may therefore become highly transactional requiring a high standard of book keeping. The creation of a number of sub trusts within the EBT therefore reduces the burden and allows the member/beneficiary to adopt their own approach to investment. This may mean that the Trustees, with your support, will need to consider the individual employee's Attitude to Risk and investment theme for each sub trust.

It is at this point that the importance of highly practiced professional trustees becomes essential, as not only will they have experience in administering multiple sub trusts, but they will also have the administrative capability to manage the process.

EFRBS

What is an EFRBS?

An EFRBS is a form of EBT where benefits will only be provided in specified limited circumstances, principally being retirement or death, or a change in the nature of the service of an employee. The focus, therefore, of an EFRBS is retirement type benefits, but outside of some of the restrictions imposed by the registered pension scheme legislation. It is most commonly a funded arrangement, but will generally involve employer contributions only.

The use of an EFRBS alongside, or in place of, a registered pension scheme is an option in which there is significant current interest, particularly for 50% tax payers.

Advantages of an EFRBS, compared with a registered pension scheme, include;

- (a) flexibility of investment policy; and,
- (b) flexibility in the provisions of benefits (including the use of lump sums, benefits to family members and the absence of the requirement to take an annuity on retirement).

An EFRBS has further advantages over a registered pension scheme in that it is not subject to the annual allowance in contributions or the lifetime allowance charge on payments out. Nor is it subject to the new special annual allowance charge introduced as part of the scheme of restricting pension tax relief for 50% income tax payers.

EFRBS and IHT

The value of the EFRBS is likely to be within the charge to IHT (unless it also qualifies as a Qualifying Non UK Pension Scheme or QNUPS which is generally unlikely). However, unlike a registered scheme, an EFRBS avoids the unauthorised scheme charges that otherwise arise if a member dies after age 75 without having an annuity.

What is the tax position for an EFRBS member?

Where benefits are paid out of an EFRBS, the receipts are employment income. However, unlike receipts from an EBT, only 90% of the sums withdrawn will be subject to income tax if the benefits are paid by an offshore EFRBS to a UK resident beneficiary, in the style of a UK registered pension, ie up to 25% lump sum (90% of which is taxable) and an income thereafter.

In addition, it is currently thought to be HMRC's position that payment by an offshore EFRBS to a beneficiary who is non UK resident at the time of receipt of the benefit will not be subject to UK employment taxes. So, for employees who could become non resident in the future, an EFRBS arrangement may be particularly attractive at a time of increased income tax rates.

Generally, the receipt of benefits from an EFRBS (unlike an EBT) will not be subject to NICs, if, had the scheme been a registered pension scheme, the payment would have been an authorised payment (ie a pension or up to 25% lump sum payment within the UK pension rules). Any payments that would be treated as unauthorised payments from a UK registered scheme would not benefit from relief against NICs and would be fully taxable ie the 10% tax free element would not apply.

What is the tax position for the employer company?

The position of the employer company on payments into an EFRBS is the same as an EBT. The key issue for the employer company again will be the impact of the deferral of corporation tax relief.

A final word

There is no doubt that an EBT and an EFRBS are potentially extremely useful remuneration planning tools, but their use should always be carefully considered within the individual circumstances of each case, with regular checks on their legal and tax position. Particular care needs to be taken where:

- Participators in a close company are intended to be the beneficiaries
- Companies wish to claim up front deductions for benefits which are to be paid into the EBT or EFRBS and
- Employees intend to take immediate and potentially long term loans out of the trust funds (both from an EBT and from an EFRBS).

Legislative changes are likely, although the issue that HMRC will face is distinguishing between genuine incentive arrangements and purely tax motivated structures. For the employee, of course, the issue may simply be one of taking a view on income tax rates in the medium to longer term, and the timing of any future rate income tax reductions.

Appendix 2 – Factsheet comparing EBTs, FBTs and EFRBS

Employer sponsored trusts, with the exception of registered pension schemes, come in three forms: Employee Benefit Trusts (EBTs), Family Benefit Trusts (FBTs) and Employer Funded Retirement Benefit Schemes (EFRBS). Other names may be used but these will be marketing names for one of these structures.

An FBT is an EBT where the funds have been allocated from the main EBT discretionary trust to a specific pot (sub trust) for a particular sub-set of beneficiaries. EFRBS are established for a single employee of the company and so sub trusts do not apply.

With minor exceptions, the taxation treatment of EBTs, EFRBS and FBTs is therefore identical – with the exception of close companies. The differences in tax treatment arise from the nature of the sponsoring company rather than the structure (or name) of the employer sponsored trust.

Employer Sponsoring the Trust is a company that is not a close* company			
	EBTs	EFRBS	FBTs
On or Offshore	Can be either, but almost always offshore		
Is a corporation tax deduction available on transferring to the Trust.	While some advisers suggest the answer is Yes, HMRC are clear that the answer is No		Not applicable
Income tax liability on transferring to the Trust	No income tax liability arises on the transfer of funds to the trustees	No income tax liability arises on the transfer of funds to the trustees	No income tax liability arises, provided the transfer to the sub trust is revocable
Taxation within the Trust	Investment returns, gains and income will not be subject to UK tax with the exception of income tax on UK source income		
Income tax and National Insurance on distributions from the Trust	Distributions will be treated as employment income. NIC may not be payable if the individual is no longer employed	Distributions withdrawn as income (a pension) will be subject to income tax on 90% of the distribution. No liability to NIC provided distribution is made post retirement	Distributions will be treated as employment income. NIC may not be payable if the individual is no longer employed
Corporation tax deduction on distribution from the Trust	A deduction is available at the point funds are distributed to the beneficiaries (excluding loans)	A deduction is available at the point funds are distributed to the beneficiaries (excluding loans). Allocation of funds to a sub trust does not permit a deduction	
Are there any IHT implications?	Transfers are not CLTs and although relevant property, periodic or exit charges can normally be avoided. Assets do not usually fall within the member's estate for IHT purposes.	Transfers are not CLTs however it is relevant property. Periodic and exit charges apply and the assets would normally fall within the member's estate for IHT purposes.	Transfers are not CLTs and although relevant property, periodic or exit charges can normally be avoided. Assets do not usually fall within the member's estate for IHT purposes.

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Is a corporation tax deduction available on transferring to the Trust?	While some advisers suggest the answer is Yes, HMRC are clear that the answer is No.		Not Applicable
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Taxation within the Trust	Investment returns, gains and income will not be subject to UK tax with the exception of Income Tax on UK source income		
Income tax and National Insurance on distributions from the Trust	Distributions will be treated as employment income. NIC may not be payable if the individual is no longer employed	Distributions withdrawn as income (a pension) will be subject to income tax on 90% of the distribution. No liability to NIC provided distribution is made post retirement	Distributions will be treated as employment income. NIC may not be payable if the individual is no longer employed
Corporation tax deduction on distribution from the Trust	A deduction is available at the point funds are distributed to the beneficiaries (excluding loans)		A deduction is available at the point funds are distributed to the beneficiaries (excluding loans). Allocation of funds to a sub trust does not permit a deduction
Are there any IHT implications?	In order to avoid a CLT arising, the participators (including their families) must be excluded from benefit. Periodic & exit charges will still apply	In order to avoid a CLT arising, participators (including their families) must be excluded from benefit. Periodic & exit charges will still apply	As for EBTs but with no additional IHT implications on transfer to the sub trust. Periodic & exit charges will still apply

* A close company is one where there are five or fewer shareholders