

Employee Trusts

Employee benefit trusts were at one time widely used as vehicles to avoid income tax liability on substantial bonuses paid to employees. The plan was quite simple in design. The company would contribute funds to the trust, often located offshore. Those funds would then be lent to the employee who should thereby suffer no more than a benefit in kind charge at the official rate of interest, instead of 40 per cent income tax liability. In addition, the company should have a deduction from its profits, since the money was laid out for the purposes of its trade.

This simplified form of planning was brought down in the *Dextra* case in which it was held that the payments to the trust were 'potential emoluments' of employees and were therefore subject to the rule that the payer got no deduction until the relevant employees were taxed on the funds as emoluments.

Whilst this makes employee trusts much less attractive to major companies, family companies could still see the advantage of using such trusts to extract funds from the company, particularly if the profits of the company were within the lower rate of corporation tax applicable to small companies. Accepting the lack of tax relief within the company then costs only 21 per cent corporation tax, instead of 40 per cent income tax plus employers' National Insurance contributions. Unfortunately, a recent announcement by HMRC seeks to twist the knife further in relation to this type of planning. HMRC point out that gifts by close companies are apportioned amongst the participators for inheritance tax purposes and then treated as chargeable transfers made by the participators. This will give rise to 20 per cent inheritance tax liability, unless the nil rate band is available. Any one of three exemptions, as below, could be claimed, but HMRC deny that any of them is available:

1. Gifts by close companies to employee trusts – these can be exempt under s 13, IHTA 1984, but not if participators in the company are potential beneficiaries under the trust. HMRC claim that it is not good enough simply to exclude the participators from benefit under the terms of the trust, and then to make loans to them at the official rate of interest since this is still a benefit to them, thus contravening the exemption.
2. Dispositions allowable as a deduction in computing profits for corporation tax purposes - s 12, IHTA 1984 allows an exemption for such payments, but HMRC claim that this exemption only applies if the transfer to the employee trust is immediately deductible for corporation tax purposes, and not potentially deductible in a future year when benefits are paid out of the trust.
3. Transactions such as might be expected to be made at arm's length between third parties - these transactions are exempt under s 10, IHTA 1984 so long as there is no gratuitous intent. However HMRC say that there will always be an element of gratuitous intent in forming an employee benefit trust for members of a family.

HMRC's claims in relation to (1) and (2) above looks to be reasonably based arguments, albeit not beyond dispute. However it is known that leading tax counsel has advised that the exemption under (3) is generally available in these circumstances, since this type of planning has commonly been adopted in the past, particularly by major banks in relation to their annual bonus payments. No doubt a case will surface in due course when the merits of HMRC's three points will be examined.

Although the announcement by HMRC places a considerable question mark over the use of employee trusts as a means of extracting profits from a company, it should not be overlooked that they still have other uses in terms of general inheritance tax planning. The funds in an employee trust, whether or not it includes the participators in the relevant company, are not within the normal ten-year inheritance tax charging regime, but are instead subject to a regime of special charges under s 79, IHTA 1984. These special charges can, in the longer term, be higher than the normal inheritance tax ten-yearly charges. Even so, it can be possible to save significant amounts of inheritance tax by converting an existing trust shortly before a ten-year anniversary date into an employee trust and then at some subsequent time converting back to a general trust. This will be of particular relevance where the trusts holds shares in a family investment company. One will need to take particular care with regard to any distributions from an employee trust, since these could well be liable to income tax as benefits by reason of employment, but simply converting the trust should not give rise to income tax liability.

Another use of employee trusts in relation to a family investment company is that a gift of shares into the trust can be an exempt transfer under section 28 so long as none of the participators (i.e. shareholders) is a beneficiary of the trust, nor anyone who has been a participator in the last ten years, nor anyone connected with such participators. At first sight this may appear to prevent tax planning by means of this exemption, but this will not always be the case. For example, on the death of the principal shareholder in the company, it may be possible for his or her shareholding to be left on employee trusts with the benefit of inheritance tax exemption, and of course the normal tax-free uplift of capital gains tax base cost to probate value. The trust will need to be carefully designed to secure the benefit of the exemption, but in appropriate circumstances the tax exemption may be well worth it.

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