

EFURBS

Efurbs are currently being marketed quite aggressively as a tax-efficient way of extracting profits from family companies. The acronym stands for Employer Financed Unapproved Retirement Benefit Scheme. Parmentier Arthur does not market these schemes, but the comments here are offered as impartial view on the advantages and disadvantages of these arrangements.

Efurbs are basically family trusts which can be set up by any company with distributable profits which the directors or shareholders wish to extract as tax efficiently as possible. The basic strategy under the marketed schemes is that the company transfers its profits into the trust and the trust then lends them out to either the directors or other family members who will have to pay interest to the trust. Loans to directors or employees can be interest free once the individual concerned reaches normal retirement age, but there will still be a tax charge based on the benefit in kind of an interest-free loan.

The company gets no deduction against its profits until the benefits emerge from the trust in taxable form (although some argue that the relevant legislation inadvertently fails to achieve this with Efurbs and there is immediate tax relief. Under the marketed schemes, the main idea is that any taxable benefits are indefinitely postponed, so that it is accepted that there will not in practice be any deduction for corporation tax purposes. Even so, the profits are effectively extracted at a tax cost of the company's marginal rate of corporation tax, normally either 21 or 28 per cent, plus the tax due on the loan interest or loan benefit. That should be considerably more tax efficient than taking out either salary or dividends. Equally, if one were to take a loan direct from the close company, this would require the company to deposit tax on the loan at an amount of 25 per cent of the loan until such time as the loan is repaid. So far, so good therefore, and it is clear that the schemes can produce significant immediate tax savings.

It is generally suggested that the trusts should be operated indefinitely on the basis of loans to family members in order to preserve the tax efficiency. This is a perfectly acceptable way forward, although it needs to be borne in mind that in practice the time may well come when the funds will need to be taken out of the trust. For example, in a divorce situation it is hardly likely that the claimant spouse would be happy to accept a settlement in the form of a loan from the trust. He or she will require an outright cash payment. Equally, on the death of a borrower from the trust there may not be sufficient funds in the estate to repay the loan, if the borrowed funds have been unwisely invested, or simply spent on holidays or other living expenses. In that event, either the beneficiaries of the estate must take over responsibility for the loan, or alternatively the trustees may agree to write it off. If it is written off there will be no deduction for inheritance tax purposes in respect of the debt.

Any distributions from the trust, or loans written off, are likely to be taxable in full at the top rate of income tax. At the same time, this will produce a matching deduction for the company in its corporation tax computation. Of course, by that time the company may have been wound up or sold, in which

event the corporation tax deduction will be of no interest to the family members. The income tax charge on distributions and loans written off is nebulously worded and the boundaries of exactly when liability arises and when it does not are ill defined. Certainly distributions to employees or past employees can be expected to give rise to full income tax liability; note in particular that the liability is not on amounts up to the total of contributions into the trust, but income tax liability on the full sum. Some of the distribution may represent income or gains which has already been taxed in the trust, and in that event there is double tax liability. There is a concession which may offer some relief in relation to income tax, but all Inland Revenue concessions are being progressively withdrawn, with some of them recast into a roughly equivalent statutory relief.

It will be seen that 40 per cent (or even 50 per cent in the future) tax liability on the distributions from the trust plus the corporation tax liability initially paid in the company amounts to a much heavier tax burden than if the company had simply paid out dividends and there had never been any trust. Payments or benefits from the trust may also be liable to National Insurance contributions; there is no specific legislation in the NIC provisions relating to Efurbs, and it will be a question of whether the distributions or benefits count as 'earnings'.

To summarise, those entering into these schemes will need to work on the basis that the trust will need to continue for a long period of time and extracting funds from it other than by way of loan will normally cause the tax savings to unravel, and in some cases may cause higher overall tax liability. On the other hand, those who are prepared to set up a structure which will remain in place long past their deaths may expect to see long term tax savings. We can expect the annual benefit in kind charge on loans to increase from its current figure of 4.5 per cent in the future and even at 4.75 per cent, the whole loan will effectively have borne an income tax charge after 21 years, with the money will still not belonging to the borrower. A tax deferred may be a tax saved, but in this case the deferred tax does not produce the same result as if an immediate up-front charge were accepted – the money is still in the trust and there is no credit for on distribution for tax already paid on benefits. On the plus side, there is the initial income tax saving to be brought into account which might have been invested to grow to a considerable sum over the years.

The trust itself does not benefit from any tax exemptions and will be taxed the same as any other family trust. Some of the publicity refers to them being 'HMRC approved'; what this refers to the reporting requirements when the trust is set up, but HMRC will do no more than accept at face value that the trust is genuinely a retirement benefit scheme. This is different from HMRC granting 'approval' as it does to a registered pension scheme.

One might wonder therefore what the consequences would be if the trust is not operated as a retirement benefits scheme, for example if interest-free loans were made to those who are not retired. The answer to this is that the consequences could be quite dramatic. Normally on setting up a family trust

an inheritance tax liability at the rate of 20 per cent is incurred, and this applies just as much where the funds are transferred in by a close company (in which event the transfer is apportioned to the participators and liability arises on them). A transfer to an Efurbs is an exempt transfer but if it comes to the attention of HMRC that the Efurbs is not being operated as a genuine retirement benefit scheme, they may well seek inheritance tax liability on the participators for the funds transferred in. There is no general six-year limitation period for past inheritance tax liability, and HMRC can seek to enforce an inheritance tax charge for a date long before six years previous. HMRC state that they may also seek to treat the trust as a settlor-interested trust, with income tax liability on the company directors, this presumably being based on the notion that they allowed their earnings to be diverted into the trust of which they are indirectly the settlors. The trust might also be caught by the inheritance tax gift with reservation provisions, although there are arguments against this treatment.

All in all, the initial tax savings from these schemes can unravel in later years, sometimes causing even greater liability. Distributions to family members after the death of a director/employee have the best hope for escaping full income tax liability, but that circumstance may not be available until far into the future. Accordingly, those considering the schemes should look at what the long term strategy with the trust is going to be, and should consider whether or not there will be an overall saving of tax under that strategy.

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