EMPLOYEE BENEFIT TRUSTS – RIP?

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Background

2002 was the year in which the employee benefit trust ("EBT") regime reached a great but, very short-lived, height. This zenith occurred on 3rd September 2002, when the Special Commissioners found for *Dextra Accessories Limited*[1] to the effect that an EBT which had provided many millions of pounds of benefits to six principal beneficiaries and others had been successful; the company was entitled to a significant deduction, and the beneficiaries escaped income tax. The countervailing nadir (some might say the revenge) occurred on 27th November 2002, when the Inland Revenue introduced new provisions to widen significantly s.43 Finance Act 1989, with the effect that, broadly speaking, no sponsoring company may thenceforth obtain a deduction for a contribution to an EBT until benefits have been paid out to beneficiaries. The effect of denying a deduction can be well described by referring to the prescient words of the Special Commissioners in the *Dextra* case. They said (at paragraph 19 of that case) –

> "[The facts] show that the company and the directors were strongly influenced by tax considerations, but this is not surprising when dealing with an EBT which would not be much of a benefit if the employer could not obtain a deduction …"

How did we get here?

EBTs began to be popular prior to the 1980 changes to the corporate buy-back rules, as they could operate as a market for the shares of companies which could not be repurchased by the company. They took the form of discretionary settlements which were intended to incentivise staff on the basis that the company would pay sums into an EBT and in due course benefits would be made available by the trustees to the staff. In order to encourage the use of EBTs, generous tax benefits flowed. By s.86 of the Inheritance Tax Act 1984, EBTs were relieved from the ten-year charge otherwise applicable to discretionary trusts; through s.13 (subject to the involvement of participators) the creation of an EBT did not amount to a transfer of value; under s.12 there was no transfer of value, in any event, where the company's contribution to the EBT obtained the benefit of a tax deduction for the purposes of corporation tax.

But it was the asymmetry of EBTs which appealed to companies and tax planners alike and which, no doubt, offended the Inland Revenue. At paragraph 17 of the *Dextra* case the Special Commissioners said as follows –

> "We quite understand the Revenue not liking the asymmetry of the companies obtaining an immediate deduction for payments into trust without any charge to tax on the employee except perhaps a charge to tax on interest-free loans at the official rate, and not even that if the official rate is paid … However, it is in the nature of employee benefit schemes that the employer should obtain a deduction having paid away money to such a trust. The reason why the

> employees are not taxed on funds in the EBT is simply that they do not belong to the employees. The [employees] may have carried this to extremes by not taking any significant remuneration in cash but their position is entirely different from what it would have been if they had.

If this asymmetry were not unpalatable enough, what probably discomforted the Inland Revenue more was the fact that EBTs were increasingly being used as vehicles for fairly extravagant tax planning. In due course, the Inland Revenue began to devote great energies in investigating EBTs, such that the Special Compliance Office became involved and would raise typically a number of points, which I now consider in turn. As can be seen, the majority of these were raised in the *Dextra* case.

Urgent Issues Task Force Abstract 13 – "UITF 13"

The Inland Revenue used to argue that UITF 13 had application to EBTs (the company and the EBT are effectively one single arrangement), with the consequence (so the Revenue contended) that an EBT's assets should be treated, in effect, as remaining in the company's balance sheet, and no deduction should be given to the company until those assets passed out to a beneficiary. This view always struck me as hopeless. Indeed, it is perhaps noteworthy that it was not even raised in *Dextra*, although by the time of the hearing UITF 13 had been superseded by UITF 32 and UITF 32 effectively threw (extremely) cold water on the UITF 13 arguments anyway. Be that as it may, UITF 13 was concerned principally with ESOP trusts which are run in tandem with sponsoring companies rather than what one might call "normal" trusts, exemplified by EBTs which are quite separate, as a matter of law, from sponsoring companies. More particularly, the trustees of an EBT were independent from the sponsoring company, and they acted in accordance with their own constitution as applied by those trustees. It is unlikely that any trust lawyer would ever consider that the assets of a trust belonged to the settlor company in these circumstances. To be fair to the Inland Revenue, many EBT trustees did seem to be in thrall, to say the least, to the sponsoring companies, leading to an unhealthy relationship which fuelled the Revenue's general concerns no doubt: indeed, in *Dextra*, the Revenue argued *Ramsay* forcefully on the basis that the companies and the EBT were so interlinked as to amount to a single vehicle producing guaranteed emoluments or benefits as part of a tax avoidance arrangement. (This Revenue view failed, as to which see later).

Another counter to UITF 13 applying was that had it done so it would have produced both bizarre and misleading effects. For example, assume that an EBT, over time, has acquired more than half of the shares of its own sponsoring company (perhaps even 75% of those shares). By virtue of the UITF 13 argument advanced by the Revenue, the position would be that even though as much as 75% of the company's shares were owned by the EBT, nevertheless, the correct accounting treatment (apparently) would be (somehow) to record those assets as on the company's own balance sheet. Or, assume that a company has transferred £1m. of cash to an EBT, which has been invested by the trustees, and assume also that in due course the sponsoring company goes into liquidation without any assets. The UITF 13 stance shows the £1m. as an asset of the company. A creditor of the company owed, say, £1m. might not be "best pleased" to find that the accounts of the sponsoring company were "misleading", in suggesting that the company retained £1m. of assets. There is little doubt that a liquidator would not have access to those assets and certainly could not claim that they remained in the ownership of the company.

I should say that it is my view that the new UITF abstract 32 should still not catch EBTs, provided that the sponsoring company can show that it does not control the EBT as more fully set out in paragraph 10 of that abstract.

Section 43 Finance 1989

The provisions of s.43 FA 1989 were debated in *Dextra*. Section 43 provides, in essence, that where relevant emoluments or potential emoluments are transferred to an intermediary, with a view to their becoming actual emoluments in due course, no deduction occurs until (again in broad terms) emoluments representing that intermediate payment are paid out. The Revenue maintained that their view – to the effect that s.43(11) applied in the circumstances – produced the necessary and desirable symmetry between the deductibility of the companies on the one hand and the taxability of the employees on the other. By contrast, the taxpayer argued (successfully as it turned out) that payments made to an EBT were neither relevant emoluments nor potential emoluments, since there was no guarantee that they would be transferred out in due course as emoluments: they might take the form of loans or other benefits. And in *Dextra* very significant interest-bearing loans had been made to beneficiaries. Further, if the Inland Revenue's argument was correct, this would mean that there would never be a deduction and that was an indication of the fallacy in their approach. The Commissioners preferred the taxpayer's argument (s.43 was not in point) and it was largely as a result of this (one assumes) that the new draft Schedule, widening s.43, was introduced on 27th November 2002.

As a footnote to the above, I might add that the Inland Revenue have appealed *Dextra* to the High Court exclusively by reference to s.43, so it is understood. This would seem to be a difficult argument to sustain given the Inland Revenue have separately given instructions to the Parliamentary draftsman that s.43 needed to be widened: why request that legislation be fixed if it is not broken?

Benefits in kind

The second main argument which the Inland Revenue ran in *Dextra* was one which had concerned a great many tax advisers previously. The Dextra trustees (as one might call them) had created sub-funds for the benefit of particular beneficiaries, and, so the Inland Revenue argued, this created a benefit in kind taxable under the general provisions of taxing benefits in s.154 of the 1988 Act.

By contrast, the taxpayer argued (successfully again, as it turned out) that the specific charging provisions in s.154 required actual benefits to be received rather than potential benefits being available. Having regard to *Templeton v. Jacobs*[2], the position is that "no benefit is provided for the purposes of s.154(1) until the benefit in question becomes available to be enjoyed by the taxpayer". The Commissioners agreed: an interest in a trust could not produce an availability for trust assets to be enjoyed – that would involve another step such as an appointment to the employee out of the trust. So there was no benefit in kind in relation to a sub-fund.

Templeton v. Jacobs is an increasingly important case in the area of employee benefits. The case concerned an individual who, whilst working for a firm of solicitors, accepted a job with a client company, which job was to take effect subsequently. In the meantime, the client company agreed to pay for a loft conversion to the individual's house (from which he would work for the company), and the company paid for the cost of that loft conversion immediately (at a time when the individual was still in employment with the solicitors). The taxpayer argued that this sequence of events meant that he was not subject to tax on the benefit in kind representing the loft conversion, because at the time when payment for the loft conversion had been made he was not employed by the client company:

payment for a benefit was synonymous with *provision* of that benefit. However, as stated, the High Court held that the relevant time for taxation purposes was when the benefit itself became available, being the time when the loft was completed. By this time Mr. Jacobs *was* working for the company, having left the firm of solicitors, and therefore he was taxed on the benefit in kind which was made available at a time when he was in employment with the employer in question.

The ratio of *Templeton v. Jacobs*, therefore, is that provision of a benefit occurs only when it is received. This rule enabled Dextra to win the benefit in kind argument, and, as an aside, it means that tax advantages may follow if benefits in kind are provided to employees *after* retirement: the provision of the benefit will occur when no "charging" employment exists.

The *Ramsay* argument

The final argument which the Inland Revenue ran in *Dextra* was in relation to *Ramsay*. The argument was that there was a single pre-ordained plan involving the companies and the trustees by which plan the six principal beneficiaries would receive (or be entitled to) remuneration (in some form) in a guaranteed fashion: the EBT was a conduit artificially inserted into the process of remuneration. The Commissioners dismissed this contention, since, having regard to the particular facts, it was not the case that there was an inevitable result which would produce cash in the hands of employees. Thus it could not be said, adopting a commercial approach to the relevant statutory concepts, that in the circumstances there was a payment of emoluments or earnings by reason of the particular arrangements involving the EBT. The Commissioners even went so far as to say that they did not categorise the EBT as an artificial tax avoidance scheme.

27th November Changes

Probably in reaction to the *Dextra* case in general (which had originally been intended to be an anonymised case, but which, by contrast, was very widely trumpeted in the Press) and perhaps specifically by reference to the Commissioners' finding that no artificial tax avoidance was involved, the Inland Revenue introduced the new wording, already mentioned in this article, widening s.43. The definite consequence is, in the writer's view, that there is little point in companies setting up EBTs from the 27th November 2002 onwards, because, of course, contributions will no longer produce a deduction for the companies unless and until the EBT itself transfers to beneficiaries the cash or assets representing the contributions. This is likely to make EBTs prohibitively expensive.

The future

By way of conclusion, therefore, it can be said that the future for new EBTs is bleak but the future for existing EBTs is, if anything, enhanced. This is because *Dextra* gives good authority for the proposition that interest-bearing loans may be made to beneficiaries (the Commissioners accepted that these were not emoluments or taxable benefits in kind) without causing a tax charge, and sub-funds may be created without giving rise to a benefit in kind or deemed emolument.

Otherwise, tax practitioners will have to look at other techniques for remunerating staff in an efficient manner without the use of an EBT, and these might include the following –

(a) a transfer of deferred shares so that the taxation charge occurs early and any subsequent growth occurs income tax-free in the hands of the employee;

(b) the use of s.140A Taxes Act 1988, which allows shares to be transferred on a conditional basis without an immediate charge to tax occurring;

(c) the use of options where s.135 Taxes Act 1988 has no application so that one is thrown back onto the old *Abbott v. Philbin*[3] analysis that options are taxable when granted and subsequent benefits are ignored for income tax;

(d) the use of options under the Enterprise Management Incentives (EMI) legislation;

(e) the use of soft currency loans (if one wishes to be aggressive); and

(f) a reinvestigation of post-retirement benefits, particularly because *Templeton v.*

> *Jacobs* as confirmed by the *Dextra* case (to the extent that a Special Commissioners case may do this) does seem to show, as described in this article, that – with care – benefits in kind may be paid tax-free to individuals once those individuals have ceased employment.

Caveat

As with my previous articles, my intention has been to stimulate thought. If readers wish to proceed on the basis of this article they should do so with care.

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[1] SpC 331 – [2002] STC (SCD) 413.
[2] [1996] STC 991.
[3] 39 TC 82.