# TAXATION

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# Cunning disguise

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HMRC do not like employee benefit trusts. Nigel Holmes and Graham Poles examine the state of play, problems, and planning opportunities.

## Key Points

- HMRC's barrage of anti-employee benefit trust measures.
- Corporation tax relief depends on payment being made under FA 2003, Sch 24.
- Possible solutions to an inheritance tax charge.
- Despite the Sempra and Dextra cases, HMRC offer a settlement opportunity.
- Disguised remuneration, ITEPA 2003, Part 7A, and loans to employees.

We have been advising on employee benefit trusts (EBTs) since the late 1990s. In that time we have seen three Labour governments, one coalition government, the turn of the 21st century and concerns over the millennium bug.

We have had the 9/11 and 7/7 terror attacks, and the rise and fall, and rise again, of *Big Brother* on TV. What we have also had are numerous attempts by HMRC to tackle what they see as the perceived tax-avoidance mechanisms used by EBTs.

Let us take a quick look back to what has been happening in tax in relation to these trusts, and similar entities, since the turn of the millennium only 11 years ago.

We have had UITF 32, actually an accounting pronouncement and there have been two significant cases; these were Dextra Accessories ***(Dextra Accessories Ltd & Others v MacDonald* [2005] STC 1111** [2]**)** and *Sempra Metals* ***(CIR v Sempra Metals Ltd* [20071 STC 1559** [3]**).**

In terms of legislation, there was **FA 2003, Sch 24** [4] (now at **CTA 2009, Part 20 Ch 1** [5]) - s 1290 to s 1297).

Then there were the HMRC 'spotlights', in particular Spotlight 5, and Revenue & Customs briefs 61/09 and 18/11.

On 9 December 2010, we had the delight of the 'disguised remuneration' draft legislation **(ITEPA 2003, Part 7A** [6]**)** to contend with. This has been followed by three versions of frequently asked questions, various changes to the legislation and **208 pages of draft guidance** [7]) that will become the relevant pages in HMRC's manuals.

Finally, for the purposes of this quick recap, we have had an **EBT settlement opportunity** [8]

There have been a number of articles written on 'disguised remuneration', most recently **Getting from A to Z** [9] by Chris Williams.

However, we do not intend to go into vast detail again in respect of the technical issues in relation to this new legislation; instead, what we intend to cover in this article is an examination of where we are with EBTs and HMRC's stance on them.

In particular, we will focus on transactions that took place pre-9 December 2010, together with a look at some of the tax-planning opportunities that still exist for those EBTs that are already in existence.

Although many EBTs are located offshore, this article only deals with UK tax issues.

## Corporation tax

Our first recollection of HMRC's clear dislike for tax planning using EBTs relates to the corporation tax deduction. This resulted in the *Dextra Accessories* case proceeding through all the stages from the Commissioners to the House of Lords, finally ending in favour of the Inland Revenue (as they then were).

While this case was being heard, **FA 2003, Sch 24** [4] was introduced. To cut a long story short, it is fair to say that, for most EBTs, corporation tax relief is only available as and when a qualifying benefit or qualifying expense is paid in an accounting period, or within nine months from the end of the period in which the contribution was made into the EBT. A qualifying benefit is:

- a payment that gives rise to both an employment income tax and a National Insurance contributions charge; or
- a payment which would have given rise to such charges had the duties been performed in the UK; or
- a payment in connection with the termination of employment of an employee **(CTA 2009, s1292** [10]).

The legislation specifically excludes a payment or transfer by way of loan, yet the new **ITEPA 2003, Part *7A*** [6] inserts clause (6A) into **CTA 2009, s 1292** [10], which should result in a corporation tax deduction for a post-5 Apri1 2011 loan, due to such loans attracting a full PAYE and NIC charge as a result of Part *7A* Ch 2 (see below for some more thoughts on loans). Of course, one advantage of the new 'disguised remuneration' rules is that corporation tax relief is available for transactions caught by Part 7A.

If that is confusing then we apologise for the remainder of this article because the corporation tax element of EBTs is probably the easiest to follow.

## Chargeable lifetime transfers

As companies merrily set up EBTs (which are special trusts as defined by **IHTA 1984, s 86** [11] and contributed huge sums of money into them, probably the last tax on the directors' minds was inheritance tax.

Why? Because **IHTA 1984. s 12** [12] provides that there is no transfer of value for inheritance tax purposes where the payment qualifies for corporation tax relief.

What many people failed to realise was, as a result of *Dextra Accessories* and what was then **FA2003, Sch 24** [4], the Inland Revenue not only had obtained the corporation tax result they desired, but also had been given the opportunity to raise inheritance tax assessments on companies.

This surprising turn of events resulted in some companies receiving inheritance tax assessments, and others discovering that, unwillingly, the EBT contribution had used up all (or at least a substantial part) of a participator's inheritance tax nil-rate band.

So what solutions are there to this problem?

HMRC published *Revenue & Customs Brief 61/09,* setting out their understanding. It is their opinion that s 12 relief only applies if the corporation tax relief is obtained in the year of the contribution.

It remains to be seen whether this is the case and we have waited a number of years for an **EBT** test case to go through the system with regard to inheritance tax.

In some instances **IHTA 1984, s 13** [13] will provide the necessary relief from inheritance tax in respect of the contribution. This applies where contributions are made to an EBT under **s 86** [11] and the participators in a close company are excluded from benefiting from the EBT.

However, in most of the instances we have seen there is no such exclusion.

## The *Postlethwaite* case

In the 2007 Special Commissioners hearing of ***Postlethwaite's Executors v HMRC* [20071 SSCD 83** [14] it was held that a £700,000 transfer by Mr Postlethwaite's employer company into a funded unapproved retirement benefits scheme (FURBS) for the benefit of Mr Postlethwaite and his family did not constitute a transfer of value for the purposes of inheritance tax, as s 10 applied.

The transfer did not intend to confer gratuitous benefit. This, on the face of it, seemed to provide a solution, although HMRC looked to distinguish many EBT cases we were involved in from this case.

HMRC's view, once again stated in Brief 61/09, is that the s 10 test is so stringent that it is very unlikely to apply in EBT cases. This is completely at odds with the *Postlethwaite* case.

Once again, perhaps a test case is needed to establish further case law in this regard but, for the time being, using the facts of Postlethwaite should be a suitable response to HMRC in defence of an EBT inheritance tax enquiry.

Finally, with regard to inheritance tax, *Revenue & Customs Brief 18/11* superseded brief 61/09, and this publication referred to an alternative relief to s 10, s 12 and s 13 in that, for trading companies, the availability of business property relief may offer the necessary relief against a chargeable lifetime transfer arising.

This can be a complex area, but for companies facing an inheritance tax liability it may be the best solution.

Furthermore, even if no liability arises because of the size of the contributions to the EBT, the use of this relief can be used to provide sufficient comfort to allow the shareholders in companies who have made EBT contributions to undertake suitable inheritance tax planning.

## Inheritance tax: other charges

The inheritance tax charges often come as a surprise when EBTs and their sub-trusts are considered because most focus on the corporation and income tax issues. This can especially be the case when the company has successfully negotiated its way through the lifetime charge above, only for the trustees to find other charges lurking to catch them unawares.

The first of these is the charge imposed by **1HTA 1984, s 72** [15]. This is effectively an exit charge from a special trust such as an EBT so that where funds are transferred into another trust, say a family trust, a s 72 exit charge arises.

This is calculated at 0.25% of the value of the transfer for each quarter, or part of a quarter, that the funds were held in the special trust.

When the assets are held in a trust outside the EBT, they can, of course, be subject to two more charges. The first is the decennial charge, which taxes the value of the funds above the available nil-rate band at an effective rate of 6%.

In many of the cases we have seen the asset held by the trust is a loan and so, subject to any interest charges, the value remains fairly static so the extent of this charge can be easily predicted.

The second occasion of charge is if those funds are appointed before the tenth anniversary, because there will be an exit charge from the trust. The charge is calculated in the normal way, based on the number of quarters the assets have been held in the trust.

The problem is that any exit in the first ten years cannot benefit from business property relief. So even if the lifetime charge on the way into the EBT/family trust was avoided, it was not possible to exit the money from it after the first quarter without suffering the charge.

However, care is required when deciding the date the family trust was settled because of the interaction of **IHTA 1984, s 81** [16].

This section, for the purposes of the decennial and exit charges, reads back the transfer of assets between settlements to the original settlement.

Therefore, the funds held in the family trust will be read back to the original EBT which means that the decennial charge may come round more quickly than originally thought.

## Income tax

Despite income tax issues forming part of the *Dextra Accessories* case at its earlier stages, the initial lines of attack by HMRC in relation to EBTs was in relation to corporation tax, as can be seen above.

In Sempra Metals, HMRC was once again unsuccessful in arguing that a contribution into an EBT represented earnings at that point.

However, the publication of Spotlight 5 made it clear that HMRC had had a change of emphasis, and the EBT line of attack would now be income tax and National Insurance contributions.

This culminated in the publication of the draft disguised remuneration legislation on 9 December 2010, which really did take a 'sledgehammer to crack a nut' approach in order to ensure EBT transactions in the future would be subject to income tax and NICs.

But what of transactions that occurred prior to 5 April 2011 (9 December 2010 in some cases), or transactions occurring in the future that do not appear to be caught by the new **ITEPA 2003, Part 7A** [6]? We will consider these issues below, with a particular emphasis on loans.

Case law (*Sempra Metals* and *Dextra Accessories)* both support the premise that a contribution by a company into an EBT does not represent earnings at that point.

Despite this, HMRC continued to believe that contributions into an EBT, pre-Part 7A, represent earnings and they have offered companies the opportunity to settle enquiries on this basis.

This offer is completely at odds with case law and legislation and, unlike most of the other recent settlement opportunities to plumbers and the like, there is no carrot to entice taxpayers to settle, except perhaps the conclusion of a long drawn-out enquiry.

Even if an income tax liability arises as a result of a Part *7A* charge, perhaps the simplest way of mitigating the liability - if the taxpayer so wishes - is to enter into a suitable income tax relief investment product.

This, of course, carries an investment risk but it does gain income tax relief and avoids the need to undertake complex tax planning to try to sidestep the charge in the first instance.

## Loans

It is quite common for the trustees of an EBT or a related family trust to provide loans to beneficiaries, often unsecured and interest free. The new Part 7A now taxes such loans in full, and there is no clawback if the loan is repaid.

Loans granted by the trustees between 9 December 2010 and 5 April 2011 are also subject to Part *7A,* but only if the loan remains outstanding after 5 April 2012.

Loans made prior to 9 December 2010 are not caught by the new legislation. Such loans usually give rise to a benefit in kind as a beneficial loan, as described in the *Employment Income Manual* at EIM26110.

This tax treatment, as you would expect, looks through the trust to see what the tax treatment would have been had the employing company made the loan.

However, Part 7A now means there is a difference in treatment between employer-provided staff loans and EBT-provided staff loans.

What is often overlooked is that many loans are qualifying loans. A loan qualifies when the interest is tax deductible (or would have been if the loan was interest bearing). So EBT loans provided to beneficiaries to, say, purchase UK property to let, should not give rise to a benefit in kind.

Once again, this relief against a tax charge is only available for pre-9 December 2010 loans as there are no similar provisions in Part 7A.

Interestingly, the 208-page guidance that was published recently assists in clarifying two points.

First, the guidance states that writing off an EBT loan provided before 9 December 2010 is not a relevant step under Part 7A and, therefore, the tax treatment will be governed by the rules already in place within **ITEPA 2003, s 62** [17] and **s 188** [18] and so there may perhaps be instances where loans can still be written off without a tax charge occurring.

Second, the same guidance confirms that altering the terms of the loan may not be a relevant step. The trustees may agree to extend a loan before it expires rather than seek repayment and HMRC have confirmed that whether this is caught by disguised remuneration or not will depend upon the facts of each case.

While this is not absolute clarity on this point, at least HMRC will look at each loan alteration on a case-by-case basis as to whether the alterations constitute a relevant step or not.

Both of these scenarios are addressed in TEMP21 of the draft guidance.

Finally, TEMP39 of the same guidance confirms that the payment by an EBT of something that would be classified as exempt from employment income as per **ITEPA 2003, Part 4** [19] would not be caught by Part 7A.

Subject to the terms of the trust deed, this may allow trustees to make discretionary payments out of the trust tax efficiently.

In summary, the many layers of legislation and guidance on EBTs has resulted in a lot of confusion as to the tax treatment of certain transactions made by EBTs and HMRC's continuing attack on earlier transactions has not helped. We hope that this article has, at least, offered some light at the end of the tunnel.