EMPLOYEE BENEFIT TRUSTS POST *DEXTRA* AND FINANCE ACT 2006

Robert Venables Q.C.[1]

0 Scope of the Article

The decision of the House of Lords in *Dextra Accessories Ltd v Macdonald* concerned the deductibility of contributions to an employee benefit trust (EBT). Very many such trusts have been set up, most of them offshore. The law has changed considerably since the time the contributions relevant in *Dextra* were made, yet the old law will still be relevant for many years in very many cases.

In this article, I discuss the decision and the Revenue's reaction to it, including their claim that they can levy charges to inheritance tax on participators in close companies which have made contributions to EBTs. I also discuss how making tax-efficient contributions to EBTs has arguably become more difficulty since 6th April 2006 by inadvertent changes to the United Kingdom income taxation of trustees contained in Finance Act 2006.

In addition, I discuss changes to the inheritance tax treatment of employee trusts by Finance Act 2006.

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1 Bencher of the Middle Temple, Chairman of the Revenue Bar Association 2001-5, Fellow and Council Member of the Chartered Institute of Taxation, Chartered Tax Adviser, TEP. Author of *The Taxation of Trusts Post Finance Act 2006, Non-Resident Trusts, Inheritance Tax Planning, National Insurance Contributions Planning* and numerous other works on trusts and tax. Consulting Editor of *The Personal Tax Planning Review, The Offshore and International Tax Planning Review* and *the Corporate Tax Review*, all published by Key Haven.

1 *Dextra Accessories Ltd and others v Macdonald (Inspector of Taxes)*

1.1 The Facts[2]

In December 1998 six group companies set up and made contributions to an employee benefit trust (the EBT), whose trustee was an offshore trust company. In January 1999 various of the group companies resolved that they wished the trustee to provide for employees the amounts listed in a schedule, which were expressed either as rewards for past performance (this applied to three director-shareholders and the wives and the mother of two of the directors) (the six), or future performance (this applied to all the other employees). The directors had no right to remuneration in advance; remuneration had always been made in arrears depending on company results. The trustee was requested to have regard to the wishes of beneficiaries in relation to investment and disposition of the funds; the beneficiaries were informed that the trustee had a duty to invest with a long term perspective rather than for short term gains.

In March 1999 the trustee made revocable deeds of appointment creating sub-funds for each of the six. The trustee made loans out of their respective sub-funds to the six. In calculating their profits and gains the companies deducted the payments into the EBT.

The Revenue formed the view that those payments were not deductible, or, alternatively, that the sub-funds or the loans made to the six from the EBT out of the funds allocated to their respective sub-trusts were emoluments or earnings or benefits in kind. The companies and the six appealed.

1.2 The Finance Act 1989 Section 43 point on "Potential Emoluments"

1.2.1 The Statute

Finance Act 1989 section 43 provided:

> "(1) Subsection (2) below applies where—
>
> > (a) a calculation is made of profits or gains which are to be charged under Schedule D and are for a period of account ending after 5th April 1989,
> >
> > (b) relevant emoluments would (apart from that subsection) be deducted in making the calculation, and

2 Taken from the head note in the Special Commissioners' Decision, as reported at [2002] STC (SCD) 413.

(c) the emoluments are not paid before the end of the period of nine months beginning with the end of that period of account.

(2) The emoluments—

(a) shall not be deducted in making the calculation mentioned in subsection (1)(a) above, but

(b) shall be deducted in calculating profits or gains which are to be charged under Schedule D and are for the period of account in which the emoluments are paid.

…

(10) For the purposes of this section "relevant emoluments" are emoluments for a period after 5th April 1989 allocated either—

(a) in respect of particular offices or employments (or both), or

(b) generally in respect of offices or employments (or both).

(11) This section applies in relation to potential emoluments as it applies in relation to relevant emoluments, and for this purpose—

(a) potential emoluments are amounts or benefits reserved in the accounts of an employer, or held by an intermediary, with a view to their becoming relevant emoluments;

(b) potential emoluments are paid when they become relevant emoluments which are paid.

(12) In deciding for the purposes of this section whether emoluments are paid at any time after 5th April 1989, section 202B of the Taxes Act 1988 (time when emoluments are treated as received) shall apply as it applies for the purposes of section 202A(1)(a) of that Act, but reading "paid" for "received" throughout."

1.2.2 The Dispute

Hence, the crucial point was whether each employer's contribution to the EBT could be said to be "amounts … held by an intermediary, with a view to their becoming" "emoluments … allocated either (a) in respect of particular offices or employments (or both), or (b) generally in respect of offices or employments (or both)".

It seems to have been conceded by the taxpayer that the trustees of the EBT were intermediaries. Hence, the question was whether, the moment they had received a contribution from an employer, they were holding it "with a view to" its becoming "allocated" emoluments.[3]

1.3 The Revenue's Contentions

The Revenue contended before the Special Commissioners:

(i) that the contributions by the companies to the EBT were 'potential emoluments' within s 43(11)(a) of the Finance Act 1989, which provided that potential emoluments were amounts or benefits reserved in the accounts of an employer, or held by an intermediary, with a view to their becoming relevant emoluments, and under that section their deduction was prevented until the employee was taxed on the fund as an emolument;

(ii) that the allocations to sub-funds were benefits in kind taxable under s 154 of the Income and Corporation Taxes Act 1988;

(iii) that the sub-funds were to be treated as the property of the beneficiaries in that the money contributed by the companies to the EBT trustee and allocated by the trustee to the respective sub-funds was at the absolute disposal of the six as the trustee would always do what they required; and

(iv) that the EBT was a highly artificial tax avoidance scheme whose whole point, understood commercially, was to allocate bonuses to the recipients while trying to avoid the Sch E charge on emoluments.

1.4 The Special Commissioners' Decision [2002] STC (SCD) 413

The Special Commissioners' decision was, as to (i), that the words 'with a view to their becoming relevant emoluments' in s 43(11) of the 1989 Act were to be read as meaning that for the subsection to apply the contributing company's purpose in making payments to the trustee, the intermediary, had to be that the funds should be used to provide emoluments. In the instant case the companies had no such

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3 There appears to have been no argument on the meaning of "allocated". See below at 1.5.2 for my comments on Lord Hoffmann's view.

purpose. The funds were to be used as provided by the EBT, one of the possible results of which was that they would become emoluments. There were many other possible results, in particular, as had actually happened, that loans were made, which were not emoluments. It could not therefore be said that the contributing company had a view that the payments would become emoluments. Section 43 was therefore irrelevant.

The Special Commissioners' decision was, as to (ii), that allocation to a sub-fund was not a benefit in kind taxable under the general provisions for taxing benefits in s 154 of the 1988 Act[4] since that section dealt with actual benefits and not potential benefits or the possibility of benefit (with the exception of sick pay) .

The Special Commissioners' decision was, as to (iii), that a finding that the money contributed to the group to the EBT trustee and allocated by the trustee to the respective trust sub-funds of the six was at their absolute disposal because the trustee would always do what they required was not justified on the facts. The six were not free to do whatever they liked with the sub-funds which were held on the trusts applicable to them, and the loans were genuinely loans and not disguised distributions. It was material that the trustee had imposed some restraints on the type of investments in which allocated funds could be invested and that the trustee was not prepared to advance by way of loan the whole of an allocated fund. It was hardly surprising in the context of a trust established for the benefit of employees that the trustee was likely to comply with any reasonable request that was for the benefit of the beneficiaries.

The Special Commissioners' decision was, as to (iv), that a "commercial" approach should be applied in construing the relevant legislation to determine whether there had been payment of emoluments or earnings and in applying that commercial approach the facts were to be viewed as a whole. That was particularly the case where the six were taking virtually the whole of what would otherwise be their remuneration through the EBT. However, cash in the sub-fund was equivalent to cash in the individual's money-box only if the trustee was, in a commercial sense, inevitably compelled to comply with the individual's wishes which it had been found was not the case.

The taxpayers' appeals were therefore allowed.

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4 See now Income Tax (Earnings and Pensions) Act 2003 Part 3 Chapter 8, especially section 203.

1.5 The House of Lords' Decision

1.5.1 The Issue

Only the section 43 point was argued in the House of Lords.

1.5.2 The Fundamental Misconception

Lord Hoffmann gave a decision with which the other members of the House of Lords agreed,

He showed right from the start that he laboured under a fundamental misconception:

> "[3] Section 37 of the Finance Act 1989 (the 1989 Act), which inserted new ss 202A and 202B into the Income and Corporation Taxes Act 1988, changed the basis of Sch E assessment from the year in which emoluments were earned to the year in which they were paid. This gave rise to the possibility of a delay in payment causing a substantial timing disparity between the year in which the emoluments were deductible by the employer and the year in which they were taxable in the hands of the employee. Particularly in a case in which employer and employee were closely associated, for example, as a company and its directors, the tax liability of the company could be reduced without creating an immediate personal liability on the part of the directors."
>
> [4] Section 43 of the 1989 Act was intended to deal with this situation."

Even before section 37 Finance Act 1989 was enacted, an employer could obtain a tax deduction for e.g. a contribution to an employee trust years before any employee was taxed as a result (if at all).

1.5.3 "Allocated"

There appears to have been no argument on the meaning of "allocated". Lord Hoffmann said in the House of Lords at paragraph [6] "'Allocated' presumably means allocated in drawing up the accounts, as sums for which a liability to pay emoluments is regarded on accounting principles as having accrued." Yet this does not stack up. As stated above, at 1.2.2, the issue was as to the meaning of "amounts ... held by an intermediary, with a view to their becoming" "emoluments … allocated either (a) in respect of particular offices or employments (or both), or (b) generally in respect of offices or employments (or both)". If one thinks through what Lord Hoffmann was saying, the issue would thus be whether the contributions to the EBT were "amounts ... held by an intermediary, with a view to their becoming" "emoluments … allocated [in drawing up the accounts of the employer as sums for which a liability to pay emoluments is regarded on accounting principles as having accrued]" etc. Yet the accounts of the employer would not initially have made any such allocation and, even if the sums paid were eventually transmogrified into emoluments, that would not caused the accounts of the employer to be re-written. Therefore on Lord Hoffmann's own view, it is impossible to see how the contributions could have been of potential emoluments.

1.5.4 The Lords' Test

The Special Commissioners had taken the view that to qualify as potential emoluments, funds must be held with the sole purpose of paying them as emoluments.

Neuberger J had thought that they must be held with the principal or dominant intention of paying emoluments.

The Court of Appeal decided that funds were held with a view to becoming relevant emoluments if they were **held on terms which allowed a realistic possibility that they would become relevant emoluments.**

Lord Hoffmann agreed. He gave a most unusual reason, at paragraph [18]:

> "In the ordinary use of language, the whole of the funds were potential emoluments. They could be used to pay emoluments. It is true that, as Charles J pointed out, 'potential emoluments' is a defined expression and a definition may give the words a meaning different from their ordinary meaning. But that does not mean that the choice of words adopted by Parliament must be wholly ignored. If the terms of the definition are ambiguous, the choice of the term to be defined may throw some light on what they mean."

This is complete novel reasoning in a taxing statute. If a phrase is exhaustively defined, one normally forgets its usual meaning.

He gave a further reason:

> "[19] As the Court of Appeal noted, the words 'with a view to their becoming relevant emoluments' apply both to the purpose for which amounts are held by an intermediary and also to the purpose for which they are 'reserved in the account of an employer'. The words must have a similar meaning in both contexts. What,

> therefore, are potential emoluments reserved in the account which are properly deductible in computing the profits of the employer (sub-s (1)(b)) but are not already relevant emoluments? Mr Thornhill QC, who appeared for the taxpayers, said that relevant emoluments were contractually or constructively payable, whereas a reserve should properly be made for potential emoluments because they are payable only upon the occurrence of a contingency; for example, a bonus payable if a certain profit is achieved. It seems to me, however, that if that is a correct description of potential emoluments for which a reserve has been made, it would be equally true to say that amounts held by an intermediary were for the payment of emoluments upon a contingency, namely the exercise of a discretion by the trustees. In both cases, the sums in question may or may not be used to pay emoluments but there is at least a realistic possibility that they will be."

Is not the answer to Lord Hoffmann's question that "amounts … reserved in the accounts of an employer with a view to their becoming relevant emoluments" refers to a much simpler situation, namely that where at the end of an accounting period the employer has specified deducts an amount it intends to pay by way of emoluments for the accounting period some time after the end of the accounting period but is at that point under no legal obligation to pay such amount? If that is right, as I believe it is, then the intention of the employer is absolutely vital. Which is why in the parallel case of funds held by the trustees of an EBT, intention should also be vital. And it is only in the case where trustees lawfully can and must apply the funds so as to convert them into relevant emoluments that they are potential emoluments.

With the greatest of respect, in my view, the House of Lords' decision involves a gross distortion of the English language. Suppose I take the train from Paddington to Oxford one morning to meet a distinguished academic in Oxford, with whom I had an appointment. Unbeknown to me, he has died during the night. I am clearly travelling to Oxford "with a view to" meeting him, even though there is no possibility at all, realistic or otherwise, of my so doing. Conversely, it may be that murderous heathen savages have conspired to place a suicide bomber on the train. There is thus a realistic possibility of my being killed *en route*. Yet it could not be said that I am taking the train "with a view to" being murdered. The two concepts are completely independent and distinct.

2 The Current Relevance of *Dextra*

2.1 The Four (Main) versions of Finance Act 1989 Section 43

2.1.1 Original Version

This was the version on which *Dextra* was decided.

Relevant Parts are taken from Tolley's Yellow Book 2002/03:

"(1) Subsection (2) below applies where—

(a) a calculation is made of profits or gains which are to be charged under Schedule D and are for a period of account ending after 5th April 1989,

(b) relevant emoluments would (apart from that subsection) be deducted in making the calculation, and

(c) the emoluments are not paid before the end of the period of nine months beginning with the end of that period of account.

(2) The emoluments—

(a) shall not be deducted in making the calculation mentioned in subsection (1)(a) above, but

(b) shall be deducted in calculating profits or gains which are to be charged under Schedule D and are for the period of account in which the emoluments are paid.

(10) For the purposes of this section "relevant emoluments" are emoluments for a period after 5th April 1989 allocated either—

(a) in respect of particular offices or employments (or both), or

(b) generally in respect of offices or employments (or both).

(11) This section applies in relation to potential emoluments as it applies in relation to relevant emoluments, and for this purpose—

(a) potential emoluments are amounts or benefits reserved in the accounts of an employer, or held by an intermediary, with a view to their becoming relevant emoluments;

(b) potential emoluments are paid when they become relevant emoluments which are paid.

(12) In deciding for the purposes of this section whether emoluments are paid at any time after 5th April 1989, section 202B of the Taxes Act 1988 (time when emoluments are treated as received) shall apply as it applies for the purposes of section 202A(1)(a) of that Act, but reading "paid" for "received" throughout."

If a contribution was made in say, 2001, and section 43 operated to deny deductibility in the accounting period in which it would otherwise have been deductible, **it is still this version of section 43 which determines if and when a deduction is available. See section 43(2)(b).**

2.1.2 "Intermediate" Version

The "intermediate version" is the version as amended by Finance Act 2003 schedule 24 paragraph 11(3). Section 43(11) then read:

"(11) This section applies in relation to potential emoluments as it applies in relation to relevant emoluments, and for this purpose—

(a) potential emoluments are amounts reserved in the accounts of an employer, with a view to their becoming relevant emoluments;

(b) potential emoluments are paid when they become relevant emoluments which are paid."

The amendments to section 43 were made in relation to any time before the coming into force of Income tax (Earnings and Pensions) Act 2003: schedule 24 paragraph 11(3) and (2).

Income tax (Earnings and Pensions) Act 2003 section 723 provides:

"723 Commencement and transitional provisions and savings

"(1) This Act comes into force on 6th April 2003 and has effect—

(a) for the purposes of income tax, for the tax year 2003-04 and subsequent tax years, and

(b) for the purposes of corporation tax, for accounting periods ending after 5th April 2003.

(2) Subsection (1) is subject to Schedule 7, which contains transitional provisions and savings."

Nothing in Schedule 7 would appear to be relevant. But see paragraph 91:

"91(1) This paragraph applies in relation to corporation tax charged by reference to an accounting period which begins before and ends on or after 6th April 2003.

(2) In its application for the purposes of corporation tax, any provision of this Schedule is to be read as if—

(a) any reference to the tax year 2003-04 were a reference to that accounting period, and

(b) any reference to 6th April 2003 were a reference to the first day of that accounting period."

Hence, *Dextra* was no longer in point if the employer actually made a contribution to an EBT in the relevant accounting period (as opposed to reserving sums in its accounts).

Why was section 43 thus emasculated? Because Finance Act 2003 Schedule 24 came into effect "in relation to deductions that would (but for this Schedule) be allowed for a period ending on or after 27th November 2002[5] in respect of employee benefit contributions made on or after that date": see paragraph 11(1). And Schedule 24 had introduced new restrictions on deductions which were thought, rightly or wrongly, to enable the scope of section 43 to be restricted.

2.1.3 Income tax (Earnings and Pensions) Act 2003 First Version

"43 Schedule D: computation

(1) In calculating profits or gains of a trade to be charged under Schedule D for a period of account, no deduction is allowed for an amount charged in the accounts in respect of employees' remuneration, unless the remuneration is paid before the end of the period of 9 months immediately following the end of the period of account.

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5 the date of the autumn pre-Budget Statement

(2) For the purposes of subsection (1) above an amount charged in the accounts in respect of employees' remuneration includes an amount (a) for which provision is made in the accounts, or (b) which is held by an intermediary with a view to its becoming employees' remuneration.

(3) Subsection (1) above applies whether the amount is in respect of particular employments or in respect of employments generally.

(4) If the remuneration is paid after the end of the period of 9 months mentioned in subsection (1) above, any deduction allowed in respect of it is allowed for the period of account in which it is paid and not for any other period of account.

…

(6) For the purposes of this section, remuneration is paid when it—

(a) is treated as received by an employee for the purposes of the Income Tax (Earnings and Pensions) Act 2003 by section 18, 19, 31 or 32 of that Act (receipt of money and non-money earnings), or

(b) would be so treated if it were not exempt income.

(7) In this section —

- "employee" includes an office-holder and "employment" correspondingly includes an office, and

- "remuneration" means an amount which is or is treated as earnings for the purposes of the Income Tax (Earnings and Pensions) Act 2003."

2.1.4 Current Version (Post Finance (No. 2) Act 2005)

"43 Schedule D: computation

(1) In calculating [profits or gains to be charged under Schedule D] for a period of account, no deduction is allowed for an amount charged in the accounts in respect of employees' remuneration, unless the remuneration is paid before the end of the period of 9 months immediately following the end of the period of account.

(2) For the purposes of subsection (1) above an amount charged in the accounts in respect of employees' remuneration includes an amount [for which provision is made in the accounts] with a view to its becoming employees' remuneration.

…"

The amendment to section 43(2) was made by Finance Act 2003 Schedule 24, para 10(1) with effect for deductions that would (but for that Schedule) be allowed in respect of employee benefit contributions made after 26th November 2002.

Thus, the Income tax (Earnings and Pensions) Act 2003 first version (set out at 2.1.3) never took effect as regards income tax and has effect as regards corporation tax at the very most for an accounting period straddling April 5th/6th 2003 and in respect of contributions made before November 27th 2002.

2.1.5 General Comment on Which Version Applies

One must first ask when the relevant deduction would fall to be and when the relevant contribution was made. See Finance Act 2003 Schedule 24 paragraph 11(1).

In determining whether the pre Income tax (Earnings and Pensions) Act 2003 versions or the post Income tax (Earnings and Pensions) Act 2003 versions apply, one must have regard to when the Income Tax (Earnings and Pensions) Act 2003 came into force. There are different rules for income tax than for corporation tax. There are again different rules depending on whether the contribution was made before November 27th 2002.

If the deduction would have been allowed in a give period, but has been disallowed by section 43, one must apply that version of section 43 to determine whether it will be allowed in a future period.

2.2 Obtaining a Deduction Where Deduction Denied for a Contribution made Prior to November 27th 2002

The "original" version of section 43 will normally be in point.

Hence, one has regard to section 43(2)(b). The emoluments

"(b) shall be deducted in calculating profits or gains which are to be charged under Schedule D and are for the period of account in which the emoluments are paid."

The Revenue Press Release[6] post the House of Lords Decision states:

> "What are emoluments?
>
> HMRC accept that the term "emoluments" for the purposes of section 43 is wider than just taxable emoluments. It includes money and other benefits convertible into money, *even if there is no tax charge at that time the payments are made by the trustees,* for example as a result of a statutory exemption.
>
> A loan to a beneficiary is not an emolument. It is simply an investment made by the EBT. At some point the loan will have to be repaid and the money will then be available to the trustee to disburse in line with the terms of the trust (which is likely to be in the form of emoluments)."

The key to tax planning is the italicised words. If one can ensure that the employee receives an emolument out of the EBT, then the employer gets the deduction, even if the employee is not taxed on it. This requires a very careful consideration of the tax code. What one needs is a statutory exemption which says that an emolument is not chargeable to tax – not that something is deemed not to be an emolument.

What of the benefit in kind charges?

Compare Income and Corporation Taxes Act 1988 section 154(1):

> "Subject to section 163, where in any year a person is employed in employment to which this Chapter applies and—
>
> (a) by reason of his employment there is provided for him, or for others being members of his family or household, any benefit to which this section applies; and
>
> (b) the cost of providing the benefit is not (apart from this section) chargeable to tax as his income,
>
> there is to be treated as emoluments of the employment, and accordingly chargeable to income tax under Schedule E, an amount equal to whatever is the cash equivalent of the benefit."

with Income Tax (Earnings and Pensions) Act 2003 section 203:

6 The full text of the Press Release is set out in an Appendix to this article.

"203 Cash equivalent of benefit treated as earnings

(1) The cash equivalent of an employment-related benefit is to be treated as earnings from the employment for the tax year in which it is provided."

And see section 62:

"62 Earnings

(1) This section explains what is meant by "earnings" in the employment income Parts.

(2) In those Parts "earnings", in relation to an employment, means—

(a) any salary, wages or fee,

(b) any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth, or

(c) anything else that constitutes an emolument of the employment.

(3) For the purposes of subsection (2) "money's worth" means something that is—

(a) of direct monetary value to the employee, or

(b) capable of being converted into money or something of direct monetary value to the employee.

(4) Subsection (1) does not affect the operation of statutory provisions that provide for amounts to be treated as earnings (and see section 721(7))."

There is a technical difficulty facing employers who made a contribution when Income and Corporation Taxes Act 1988 section 154 was in force but where a charge to tax on the employee arises only under Income tax (Earnings and Pensions) Act 2003 section 203. For section 203 deems the employee to be in receipt of "earnings" but not of "emoluments". And while it follows from Income tax (Earnings and Pensions) Act 2003 section 62 that "emoluments" are "earnings", the converse is not the case.

2.3 Obtaining a Deduction Where Deduction Denied for a Contribution Made Today

Section 43 still uses the phrase "with a view to its becoming". The House of Lords' decision in *Dextra* is very likely highly relevant even today, despite the Revenue's press release:

> "*The decision … does not apply to contributions made on or after 27/11/2002, which would otherwise be deductible for periods ending on or after that date. Relief for these is governed by Schedule 24 Finance Act 2003.*"

However, the only place in section 43 where the phrase is used is section 43(2), which refers to a "provision" being made in the accounts. One can therefore get round this problem by ensuring that there is no provision in the accounts e.g. by making an actual payment to the EBT in the accounting period in question.

Note that one still has to overcome section 43(1). When is an amount "charged in the accounts in respect of employees' remuneration"? And if an employer is caught by section 43, when will it obtain the deduction? In the accounting period in which the "remuneration" is paid.

Both these questions involve asking "What is "remuneration"?" The answer is: "That which is treated as earnings for the purposes of the Income Tax (Earnings and Pensions) Act 2003." Consider again, in this context, section 203 of the Act:

> "203 Cash equivalent of benefit treated as earnings
>
> (1) The cash equivalent of an employment-related benefit is to be treated as earnings from the employment for the tax year in which it is provided."

3 What *Dextra* Did Not Decide

The Revenue conceded in *Dextra* that on ordinary accounting principles the contributions made were deductible in computing the profits of the taxpayer companies in the year ended 31st December 1998.

Avoiding Finance Act 1989 section 43 (as well as Finance Act 2003 Schedule 24) is no use unless contributions to an EBT would be deductible quite apart from those provisions.

Points to watch are:

(a) is the payment made for the benefit of the trade of the payer? Watch in particular EBTs for the benefit of all the companies in a group

(b) is the payment made wholly and exclusively for the benefit of the trade of the company rather than being a disguised distribution of profits – or worse e.g. illegal financial assistance for the acquisition of the shares in a company.

4 The Revenue's Post *Dextra* Press Release and Inheritance Tax

4.1 Extract from Press Release

"Implications for Inheritance Tax (IHT)

"Where the company making the contributions to an EBT is a close company, the outcome of this litigation is likely to have implications for IHT.

"The effect of section 13 Inheritance Tax Act 1984 (IHTA) is that an IHT charge under section 94 IHTA on transfers of capital by a close company will arise where:

- a close company transfers capital to an EBT which satisfies s86IHTA;

- the participators in that company are not excluded from benefit under the EBT, and

- the contributions are not allowable in terms of section 12 IHTA in computing its profits for CT purposes.

"In these circumstances the transfers of capital by the company will be transfers of value for IHT purposes.

"In terms of section 94 IHTA, HMRC then look through the close company and apportion the transfer of value between the participators "according to their respective rights and interests in the company immediately before the transfer". Any IHT charge therefore falls on the participators as individuals and will be at the current lifetime tax rate of

> 20% rising to 40% in the event that the participator dies within 3 years of the transfer (section 7 IHTA)."

Is this correct?

4.2 Inheritance Tax Act 1984 Section 12

Inheritance Tax Act 1984 section 12(1) provides:

> "12 Dispositions allowable for income tax or conferring retirement benefits
>
> (1) A disposition made by any person is not a transfer of value if it is allowable in computing that person's profits or gains for the purposes of income tax or corporation tax or would be so allowable if those profits or gains were sufficient and fell to be so computed."

Section 12 antedates Finance Act 1989. When it was enacted, a contribution to an EBT would either have been an allowable or it would not. There was no "wait-and-see" rule, as introduced by Finance Act 1989 section 43.

What does "allowable" mean? It seems to me that the Courts must adopt one of two extremes. Either the contribution must be known to be allowable immediately it is made or it must be simply potentially allowable i.e. one in effect disregards the effect of Finance Act 1989 section 43. In my view, I do not see how section 12 can operate on a "wait- and-see" basis. If the former construction is correct, the result would be Draconian indeed (subject to the arguments I raise below on sections 13 and 10). For even if the trustees distributed all of the contribution to employees the next day so that it became taxable in their hands, the section would not operate. There is thus a reasonable chance that the Courts would hold that it is enough to fall within section 12 that a contribution is potentially allowable i.e. that it would have been immediately allowable but for section 43.

4.3 Inheritance Tax Act 1984 Section 13

Inheritance Tax Act 1984 section 13 (Dispositions by close companies for benefit of employees) provides:

> "(1) A disposition of property made to trustees by a close company whereby the property is to be held on trusts of the description specified in section 86(1) below is not a transfer of value if the persons for whose benefit the trusts permit the property to be applied include all or most of either—

(a) the persons employed by or holding office with the company, or

(b) the persons employed by or holding office with the company or any one or more subsidiaries of the company.

(2) Subsection (1) above shall not apply if the trusts permit any of the property to be applied at any time (whether during any such period as is referred to in section 86(1) below or later) for the benefit of—

(a) a person who is a participator in the company making the disposition, or

(b) any other person who is a participator in any close company that has made a disposition whereby property became comprised in the same settlement, being a disposition which but for this section would have been a transfer of value, or

(c) any other person who has been a participator in any such company as is mentioned in paragraph (a) or (b) above at any time after, or during the ten years before, the disposition made by that company, or

(d) any person who is connected with any person within paragraph (a), (b) or (c) above.

(3) The participators in a company who are referred to in subsection (2) above do not include any participator who—

(a) is not beneficially entitled to, or to rights entitling him to acquire, 5 per cent or more of, or of any class of the shares comprised in, its issued share capital, and

(b) on a winding-up of the company would not be entitled to 5 per cent or more of its assets.

(4) In determining whether the trusts permit property to be applied as mentioned in subsection (2) above, no account shall be taken—

(a) of any power to make a payment which is the income of any person for any of the purposes of income tax, or would be the income for any of those purposes of a person not resident in the United Kingdom if he were so resident, or

(b) if the trusts are those of a profit sharing scheme approved under Schedule 9 to the Taxes Act 1988, of any power to appropriate shares in pursuance of the scheme, or

(c) if the trusts are those of a share incentive plan approved under Schedule 2 to the Income Tax (Earnings and Pensions) Act 2003, of any power to appropriate shares to, or acquire shares on behalf of, individuals under the plan.

(5) In this section—

"close company" and "participator" have the same meanings as in Part IV of this Act;

"ordinary shares" means shares which carry either—

(a) a right to dividends not restricted to dividends at a fixed rate, or

(b) a right to conversion into shares carrying such a right as is mentioned in paragraph (a) above;

"subsidiary" has the meaning given by section 736 of the Companies Act 1985;

and references in subsections (2) and (3) above to a participator in a company shall, in the case of a company which is not a close company, be construed as references to a person who would be a participator in the company if it were a close company."

The trusts of the EBT in question may or may not fall within this section. If they do, there will be no problem.

4.4 Inheritance Tax Act 1984 Section 10

If Inheritance Tax Act 1984 section 14 is not benevolently construed by the Courts and if the trusts of the EBT are such that contributions to it cannot fall within section 13, one will need to consider whether they can fall within section 10 (Dispositions not intended to confer gratuitous benefit), which provides:

"(1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either—

(a) that it was made in a transaction at arm's length between persons not connected with each other, or

(b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other.

(2) [Applies to a sale of unquoted shares or unquoted debentures]

(3) In this section—

"disposition" includes anything treated as a disposition by virtue of section 3(3) above;

"transaction" includes a series of transactions and any associated operations."

To rely on section 10, the employer (or its participators) must first show that there was no intention to confer any gratuitous benefit on any person. Now from the point of view of the beneficiaries, the benefit intended to be conferred might be thought to be "gratuitous" in that they have no legal right to have it conferred. (In some circumstances, not even that may be the case.) Yet in my view, one should look at the motive of the employer. While he will certainly have intended to confer a benefit on the employees, it will not, in my view, be "gratuitous" if it is done for selfish commercial reasons and is a motivated by a desire to benefit the employer's trade. I accept that the contrary is not entirely unarguable.

The employer must also overcome a second hurdle. The employer, qua settlor, will be connected with the trustees of the settlement. Hence, it must show that the disposition "was such as might be expected to be made in a transaction at arm's length between persons not connected with each other". It has been suggested that this condition cannot be satisfied as a gift to a trust must always be to a connected person. Yet in my view, that it to take too narrow a view of the range of transactions with which one can compare the actual transaction. It is perfectly possible for an employer to transfer assets to a third party (other than the trustees of a settlement) for no consideration on terms that the third party is bound or entitled to employ them for the benefit of employees.

5 Changes to the Inheritance Tax Treatment of Employee Benefit Trusts by Finance Act 2006

5.1 The Definition of "Employee Trust"

Inheritance Tax Act 1984 section 86 (Trusts for benefit of employees) provides:

> "(1) Where settled property is held on trusts which, either indefinitely or until the end of a period (whether defined by a date or in some other way) do not permit any of the settled property to be applied otherwise than for the benefit of—
>
> (a) persons of a class defined by reference to employment in a particular trade or profession, or employment by, or office with, a body carrying on a trade, profession or undertaking, or
>
> (b) persons of a class defined by reference to marriage [to or civil partnership with,]4 or relationship to, or dependence on, persons of a class defined as mentioned in paragraph (a) above,
>
> then, subject to subsection (3) below, this section applies to that settled property or, as the case may be, applies to it during that period.
>
> (2) Where settled property is held on trusts permitting the property to be applied for the benefit of persons within paragraph (a) or (b) of subsection (1) above, those trusts shall not be regarded as outside the description specified in that subsection by reason only that they also permit the settled property to be applied for charitable purposes.
>
> (3) Where any class mentioned in subsection (1) above is defined by reference to employment by or office with a particular body, this section applies to the settled property only if—
>
> (a) the class comprises all or most of the persons employed by or holding office with the body concerned, or
>
> (b) the trusts on which the settled property is held are those of a profit sharing scheme approved in accordance with Schedule 9 to the Taxes Act 1988, or

(c) the trusts on which the settled property is held are those of [a share incentive plan approved under Schedule 2 to the Income Tax (Earnings and Pensions) Act 2003.

(4) Where this section applies to any settled property—

(a) the property shall be treated as comprised in one settlement, whether or not it would fall to be so treated apart from this section, and

(b) an interest in possession in any part of the settled property shall be disregarded for the purposes of this Act (except section 55) if that part is less than 5 per cent of the whole.

(5) Where any property to which this section applies ceases to be comprised in a settlement and, either immediately or not more than one month later, the whole of it becomes comprised in another settlement, then, if this section again applies to it when it becomes comprised in the second settlement, it shall be treated for all the purposes of this Act as if it had remained comprised in the first settlement."

This definition has not been altered by Finance Act 2006.

5.2 The New Definition of "Relevant Property"

Settled property which is "relevant property" is in principle subject to periodic and exit charges under Inheritance Tax Act 1984 Part III Chapter III. Under the old law, the definition was such that property to which an individual was beneficially entitled was not in general "relevant property".

Section 58 (Relevant property) now provides:

(1) In this Chapter "relevant property" means settled property in which no qualifying interest in possession subsists, other than—

...."

Section 59 (Qualifying interest in possession) provides:

"(1) In this Chapter "qualifying interest in possession" means—

(a) an interest in possession—

(i) to which an individual is beneficially entitled, and

(ii) which, if the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, is an immediate post-death interest, a disabled person's interest or a transitional serial interest, or

(b) an interest in possession to which, where subsection (2) below applies, a company is beneficially entitled.

(2) This subsection applies where—

(a) the business of the company consists wholly or mainly in the acquisition of interests in settled property, and

(b) the company has acquired the interest for full consideration in money or money's worth from an individual who was beneficially entitled to it, and

(c) if the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, the interest is an immediate post-death interest, or a disabled person's interest within section 89B(1)(c) or (d) below or a transitional serial interest, immediately before the company acquires it."

Hence, settled property in which an unrecognised interest in possession subsists will normally be "relevant property". Exceptionally, it will not constitute "relevant property" if it falls within the exceptions to section 58(1), namely:

"(a) property held for charitable purposes only, whether for a limited time or otherwise;

(b) property to which section 71, *71A, 71D,* 73, 74 **or 86** below applies (but see subsection (1A) below);

(c) property held on trusts which comply with the requirements mentioned in paragraph 3(1) of Schedule 4 to this Act, and in respect of which a direction given under paragraph 1 of that Schedule has effect;

(d) property which is held for the purposes of a registered pension scheme or section 615(3) scheme;

(e) property comprised in a trade or professional compensation fund; and

(f) excluded property."[7]

5.2 Employee Trusts

There is an exception to the exception in the case of section 86 trusts (Trusts for benefit of employees) in that the new section 58(1A) to (1C) provide:

"(1A) Settled property to which section 86 below applies is "relevant property" for the purposes of this Chapter if—

(a) an interest in possession subsists in that property, and

(b) that interest falls within subsection (1B) or (1C) below.

(1B) An interest in possession falls within this subsection if—

(a) an individual is beneficially entitled to the interest in possession,

(b) the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, and

(c) the interest in possession is—

(i) not an immediate post-death interest,

(ii) not a disabled person's interest, and

(iii) not a transitional serial interest.

(1C) An interest in possession falls within this subsection if—

(a) a company is beneficially entitled to the interest in possession,

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7 Whether property comprised in employee trusts can still constitute "excluded property" is discussed by me in at 5.7.2 of my article *Impact of Finance Act 2006 Inheritance Tax Changes on Non-UK Resident Trusts* in *The Offshore and International Tax Planning Review*.

> (b) *the business of the company consists wholly or mainly in the acquisition of interests in settled property,*
>
> (c) *the company has acquired the interest in possession for full consideration in money or money's worth from an individual who was beneficially entitled to it,*
>
> (d) *the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, and*
>
> (e) *immediately before the company acquired the interest in possession, the interest in possession was neither an immediate post-death interest nor a transitional serial interest."*

The new section 58(1B)(c) would prima facie appear to be redundant. For if an interest in possession is an immediate post-death interest, a disabled person's interest or a transitional serial interest it would be qualifying interest in possession. However, the draftsman appears to have taken the view that section 58(1A) overrides section the whole or 58(1) and does not simply qualify section 58(1)(b). Although the result is a much longer section than need have been the case, its meaning at least has the advantage of being clear, once the reader has worked his way through the labyrinth.

The interaction with section 58 and section 86(4)(b) is interesting. Section 86(4) provides:

> "(4) Where this section applies to any settled property—
>
> (a) the property shall be treated as comprised in one settlement, whether or not it would fall to be so treated apart from this section, and
>
> (b) an interest in possession in any part of the settled property shall be disregarded for the purposes of this Act (except section 55) if that part is less than 5 per cent of the whole."

What if property is held on section 86 trusts but there subsist in it one or more unrecognised interests in possession each of which falls within section 86(4)(b)? In my view, one applies section 86(4)(b) before section 58, so that none of the settled property is relevant property.

5.3 Company Beneficially Entitled to An Interest in Possession

If a company is beneficially entitled to an interest in possession, the previous requirement for the settled property not to constitute “relevant property was that contained in section 59(2)(a) and (b). In addition, the new requirement in (c) as regards post B Day interests looks to whether the interest in possession was a recognised interest in possession immediately before the company acquired it.

Note that if a company now acquires an interest in possession in property to which section 71A or section 71D applies, then neither section 71A nor section 71D will thenceforth apply to the settled property in which the interest subsists, so that the interest in possession will no longer be a privileged interest in possession. However, if the vendor became beneficially entitled to the interest in possession sold before B Day, the property will not be relevant property either. Even if the company is a close company, provided it acquires the interest in possession on or after B Day, there will be no question of individuals being deemed to own the interest in possession so that there will be no charge to inheritance tax when the interest terminates or is disposed of by the company: see Inheritance Tax Act 1984 section 101(1) as modified by the new section 101(1A).

5.4 Practical Advice

Ensure that no interest in possession subsists in the settled property or that, if it does, it is in less than 5% of the whole.

6 Income Tax Changes

6.1 Overview

Finance Act 2006 section 89 and Schedule 13 have amended and amplified the income tax provisions relating to settlements contained in Income and Corporation Taxes Act 1988 and Income Tax (Trading and Other Income) Act 2005. The principal effect of some of these changes is simply to make the legislation longer.

The changes are the result of a long period of consultation between the Revenue and the public, especially the professional bodies. What has finally been enacted is very different from the original proposals. If only Gordon Brown had engaged in a similar consultation regarding the inheritance tax changes introduced by Finance Act 2006, they would either have taken a very different form or not been introduced at all.

These changes are discussed more fully in my article in *the Offshore and International Taxation Review* Finance Act 2006 Capital Gains Tax and Income

Tax Changes: Impact on Non-UK Resident Trusts.

6.2 Trustees: Artificial Person and Residence

6.2.1 The New Rule

The new Income and Corporation Taxes Act 1988 section 685E (Trustees of settlements) is in identical terms, *mutatis mutandis,* to the amended Taxation of Chargeable Gains Act 1992 section 69.

The new section 685E(1) provides

> "(1) For the purposes of the Tax Acts the trustees of a settlement shall, unless the context otherwise requires, together be treated as if they were a single person (distinct from the persons who are the trustees of the settlement from time to time)."

It does not provide that any other person shall be treated as though the trustees of a settlement were a single person. That is, it does not provide that for the purposes of the Tax Acts the trustees shall be deemed to be a single person. In the context of the capital gains tax legislation, this does not normally matter, as there are other important provisions dealing with, for example, gifts in settlement and persons becoming absolutely entitled to settled property as against the trustees of a settlement. In the context of income tax, however, there are no such other provisions.

6.2.2 Effect on Funding of EBT

6.2.2.1 Finance Act 2003 Schedule 24

Finance Act 2003 Schedule 24 (Restriction of deductions for employee benefit contributions) provides:

Restriction of deductions

1—

(1) This Schedule applies where—

(a) a calculation is required to be made for corporation tax purposes of a person's profits for any period, and

(b) a deduction would (but for this Schedule) be allowed for that period in respect of employee benefit contributions made, or to be made, by that person ("the employer").

But it does not apply to a deduction of a kind mentioned in paragraph 8.

(2) For the purposes of this Schedule an employer makes an "employee benefit contribution" if—

(a) the employer pays money or transfers an asset to another person ("the third party"), and

(b) the third party is entitled or required, under the terms of an employee benefit scheme, to hold or use the money or asset for or in connection with the provision of benefits or in respect of present or former to employees of the employer.

(3) …

…

Deductions to which Schedule does not apply

8 This Schedule does not apply to any deduction that is allowable—

(a) in respect of anything given as consideration for goods or services provided in the course of a trade or profession,

(b) in respect of contributions under a registered pension scheme or a section 615(3) scheme,

(c) in respect of contributions under a qualifying overseas pension scheme in respect of an individual who is a relevant migrant member of the pension scheme in relation to the contributions,]1

(d) in respect of contributions under an accident benefit scheme,

(e) under Schedule 4AA to that Act (approved share incentive plans),

(f) under section 67 of the Finance Act 1989 (c 26) (qualifying share ownership trusts), or

(g) under Schedule 23 to this Act (relief for employee share acquisition)."

6.2.2.2 Effect of Finance Act 2006 on Declaration of Trust by Employer Strategy?

Before 6th April 2006, it was possible for an employer to declare itself trustee of cash on the trusts of an EBT and then to retire in favour of another trustee or trustees. It would appear that deductibility of the contribution would not have been denied by the Schedule as it could not be said that the employer "paid money" "to a third person".

In the light of section 685E, that is now not so clear, although there are still tenable arguments that the strategy is viable.

6.2.2.3 Other Methods of Circumventing Schedule 24?

Other methods circumventing Schedule 24, however, remain. Were I to publish details in this Review, they would not remain for long!

APPENDIX

Revenue Press Release post House of Lords Decision

Macdonald (HMIT) v Dextra Accessories Ltd & others

1. In a unanimous verdict, the House of Lords have upheld the decision of the Court of Appeal in favour of the Inland Revenue in the case of *Macdonald (HMIT) v Dextra Accessories Ltd & Others*.

What were the facts?

Dextra Accessories Ltd and 5 other group companies made contributions to an Employee Benefit Trust (EBT), set up by the holding company of the group. They deducted these contributions in computing their taxable profits for the accounting period in which the contributions were made.

The trust deed gave the trustee wide discretion to pay money and other benefits to beneficiaries and a power to lend them money. The potential beneficiaries of the trust included past, present and future employees and officers of the participating companies in the Dextra group, and their close relatives and dependants.

The trustee did not make payments of emoluments out of the funds in the EBT during the periods concerned, instead the trustee made loans to various individuals who were beneficiaries under the terms of the EBT.

What was the point at issue?

The question was whether the companies' contributions to the EBT were "potential emoluments" within the meaning of section 43(11)(a) Finance Act 1989, being amounts "held by an intermediary, with a view to their becoming relevant emoluments".

What was the decision?

The House of Lords held that the contributions by the companies to the EBT were potential emoluments within section 43(11)(a) as there was a "realistic possibility" that the trustee would use the trust funds to pay emoluments. The Court of Appeal, agreeing with the High Court, had said that it was "rightly accepted" that the trustee was an intermediary. "With a view to" did not mean the sole purpose (as the Special Commissioners had held) or the principal or dominant purpose (as the

High Court had held).

This meant that the companies' deductions were restricted. The companies could only have a deduction up to the amount of emoluments paid by the trustee within nine months of the end of the period of account for which the deduction would otherwise be due. Relief for the amount disallowed will be given in later periods of account in which emoluments are paid.

Is the case of wider interest?

The case is of wider importance as contributions to EBTs have been a feature of a number of marketed tax avoidance schemes. The treatment set out below sets out the HMRC view of when relief is available, in light of this decision, for contributions to EBTs before the introduction of Schedule 24 Finance Act 2003.

What EBTs will be affected?

The decision applies to all EBTs where there is a "realistic possibility" under the terms of the trust deed that funds will be used to pay emoluments, however wide the discretion given to the trustees.

It does not apply to contributions made on or after 27/11/2002, which would otherwise be deductible for periods ending on or after that date. Relief for these is governed by Schedule 24 Finance Act 2003.

What are emoluments?

HMRC accept that the term "emoluments" for the purposes of section 43 is wider than just taxable emoluments. It includes money and other benefits convertible into money, even if there is no tax charge at that time the payments are made by the trustees, for example as a result of a statutory exemption.

A loan to a beneficiary is not an emolument. It is simply an investment made by the EBT. At some point the loan will have to be repaid and the money will then be available to the trustee to disburse in line with the terms of the trust (which is likely to be in the form of emoluments).

In his judgement Lord Hoffman accepted that this interpretation could lead to some employers never obtaining relief. He went on to agree with the comments of Jonathan Parker LJ in the Court of Appeal, saying that "it is the result of an arrangement into which the taxpayers have chosen to enter."

What will HMRC be doing?

The Anti-Avoidance Group has set up a team to project manage these other cases to ensure that the tax outstanding is collected systematically and consistently.

In appropriate cases, HMRC will be issuing closure notices in cases under enquiry, disallowing contributions where emoluments have not been paid.

Updated Guidance:

HMRC will be reviewing the guidance in the Business Income Manual on EBTs and other areas affected by section 43 Finance Act 1989. Where appropriate, the guidance will be updated to reflect the decision in this case.

Implications for Inheritance Tax (IHT)
Where the company making the contributions to an EBT is a close company, the outcome of this litigation is likely to have implications for IHT.

The effect of section 13 Inheritance Tax Act 1984 (IHTA) is that an IHT charge under section 94 IHTA on transfers of capital by a close company will arise where:

- a close company transfers capital to an EBT which satisfies s86IHTA;

- the participators in that company are not excluded from benefit under the EBT, and

- the contributions are not allowable in terms of section 12 IHTA in computing its profits for CT purposes.

In these circumstances the transfers of capital by the company will be transfers of value for IHT purposes.

In terms of section 94 IHTA, HMRC then look through the close company and apportion the transfer of value between the participators "according to their respective rights and interests in the company immediately before the transfer". Any IHT charge therefore falls on the participators as individuals and will be at the current lifetime tax rate of 20% rising to 40% in the event that the participator dies within 3 years of the transfer (section 7 IHTA).