EMPLOYEE BENEFIT TRUSTS AFTER THE OCTOBER 2007 PRE-BUDGET STATEMENT

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1 Overview

The optimum position is that

- an employer can obtain a corporation tax deduction for contributions without there being any PAYE, income tax charge on employment income or National Insurance Contributions becoming due, at least at that time

- the employee benefit trust's capital gains can fall entirely outside the United Kingdom tax net

- income tax and National Insurance Contributions on benefits received from the employee benefit trust can be either postponed until the time of receipt of the benefit or even avoided altogether

- the arrangement is inheritance tax efficient

2 Deductibility of Employer's Contributions

2.1 The Classic Position

Provided contributions were fact made wholly and exclusively for the benefit of the trade of the Employer (see Income and Corporation Tax Act 1988 section 74(1)(a)) and were of an income nature (see *Atherton v British Insulated and Helsby Cables, Limited* (1925) 10 TC 155; [1926] A.C. 205), they would be deductible no later than

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the accounting period in which they were actually made, whether or not there was then a charge to income tax on any employee.

Contributions made by an investment company might also be deductible, but that depended on the precise statutory provisions (which have been modified from time to time).[2]

2.2 Generally Accepted Accounting Practice

Trading accounts must now normally be drawn up in accordance with a generally accepted accounting practice.

Matters have been complicated by UITF Abstract 32. This is very much a matter of accountancy practice and not of law. The reasoning of the Abstract makes only limited sense to those trained to think like a lawyer. Nor is the language in which it is couched that used by lawyers. I myself find it far from logical and sometimes verging on the incoherent. It would appear to deny deductibility for a contribution to an employee benefit trust for so long as the assets representing the contributions can be said to be available for the benefit of the employer's business e.g. by providing future employee remuneration.

In my non-qualified view, if irrevocable sub-funds are created for the benefit of specified employees, then the Abstract will be satisfied, even if the sub-funds are held on discretionary trusts for a narrow class of beneficiaries. Moreover, it is possible to make the class wide enough so that it does not merely include the employee and members of this "family" and "household", as defined for the purposes of the Income Tax (Earnings and Pensions) Act 2003 Benefits Code, so that there is then in my view no danger of a charge to income tax on earnings when the sub-trust is created.[3]

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2 Settlors which are investment companies require special consideration and are outside the scope of this article.

3 See *Dextra Accessories Ltd and others v Macdonald (Inspector of Taxes)* [2002] STC (SCD) 413 in which the Special Commissioners accepted the taxpayer#s argument that the benefit in kind charge is on "actual benefits rather than potential benefits. The only exception is where the benefit consists of the right to receive, or the prospect of receiving, any sums which would be chargeable to tax under s 149, relating to sick pay. This is so that tax is charged on sick pay insurance premiums." They referred to *Templeton (Inspector of Taxes) v Jacobs* [1996] STC 991 at 998, [1996] 1 WLR 1433 at 1436: "No benefit is provided for the purposes of [Income and Corporation Taxes Act 1988] s 154(1) until the benefit in question becomes available to be enjoyed by the taxpayer." This part of the decision was not appealed by the Revenue.

Income Tax (Earnings and Pensions) Act 2003 section 721 (Other definitions) provides:

> "...
>
> (4) For the purposes of this Act the following are members of a person's family-
>
> (a) the person's spouse or civil partner,
>
> (b) the person's children and their spouses or civil partners,
>
> (c) the person's parents, and
>
> (d) the person's dependants.
>
> (5) For the purposes of this Act the following are members of a person's family or household-
>
> (a) members of the person's family,
>
> (b) the person's domestic staff, and
>
> (c) the person's guests."

2.3 Finance Act 1989 Section 43

2.3.1 *Dextra*

This section was enacted to ensure that deductibility was postponed until such time as there was a Schedule E charge. The House of Lords decided in *Dextra Accessories Ltd v Macdonald* [2005] UKHL 47 [2005] STC 1111 that, in effect, it applied to most contributions to employee benefit trusts.

2.3.2 *Dextra* was decided on an earlier version of the section and has only limited relevance to the present version.

Section 43 (Schedule D: computation) in so far as material, **now** reads:

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

2.3.3 Amounts Treated as Earnings

It is thus crucial to determine whether an amount "is or is treated as earnings for the purposes of the Income Tax (Earnings and Pensions) Act 2003." See Appendix A to these Notes.

Moreover, it is understood that the Revenue take the point, relying on the words in subsection (1) "*the* remuneration is paid"[4] that there must be an identity between what is paid by the employer and the remuneration received. See the Revenue's post-*Dextra* Press Release, set out at Appendix B, and in particular:

> "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)."

4 Italics added by R.V.

Realistically, the provision of such a benefit by the Trustees could well involve a charge to tax by virtue of section 203 and the amount on which tax is charged would constitute "earnings" by virtue of section 7(5)(b) and thus "remuneration" within the meaning of Finance Act 1989 section 43.

2.3.4 Section 43(1)

Section 43 in its present form can bite in one of the sets of circumstances set out in section 43(1) and (2) respectively.

Section 43(1) provides that "no deduction is allowed for an amount charged in the accounts in respect of employees' remuneration ...".

What is meant by the phrase "charged in the accounts in respect of employees' remuneration"? The decision in *Dextra* turned on whether the contributions were "potential emoluments" within the meaning of a now repealed part of the section. The Revenue appear to have taken the view that if the contributions were not "potential emoluments", then they would not be "relevant emoluments". However, in view of the fact that the House of Lords held that they were "potential emoluments", the question was academic.

I have seen the view expressed that, provided the relevant accounts do not *describe* the contributions as "employees' remuneration" then they are not charged in the accounts "in respect of" employees' remuneration. The position may be somewhat more complicated than that.

If one were being very cautious, there could be an overriding provision in the trust instrument prohibiting the trustees conferring any benefit which would be treated as "remuneration" within the meaning of section 43(1). In most cases, that would mean that no benefit at all could be conferred on an employee or on members of an employee's family or household until (at the earliest) the year following that in which his employment had, for whatever reason, terminated. Whether or not that is feasible would depend on the circumstances. If it were feasible, it would be the safest option (as well as in all probability reducing the overall charge to tax on benefits received by beneficiaries from the trust).

An intermediate course would be to ensure that the trust instrument was so drafted that the amounts paid by the employer might or might not result in employees being treated as in receipt of remuneration. One would then argue that the amounts charged in the accounts were not in respect of "remuneration" but were in respect of something which might or might not be "remuneration". I myself think this argument is correct and am fortified in my conclusion by the fact that, if it were incorrect, there would have been no need in the original section 43 for the reference to "potential emoluments". However, after the experience of the decision of the House of Lords in *Dextra*, no guarantee can be given that the Courts would agree

with me.

2.3.5 Section 43(2)

Section 43(2) provides that

> "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."

If a "provision" is made in the accounts and for sums which, once paid, will be held by the trustees on terms which allow a "realistic possibility" that they will become "remuneration", then the decision of the House of Lords in *Dextra* would be very much in point and there would be a very real risk indeed that the courts would hold that section 43(2) applied to the provision. The mere requirement of a "realistic possibility" is a very low threshold indeed.

The language of "provision" is very much part of the vocabulary of accountants. My understanding is that a provision is made in accounts precisely when no sum has been paid or expense incurred but it is apprehended that a sum will be payable in future. In my (layman's) view, therefore, the way to avoid the possible application of section 43(2) is to ensure that the payment to the Settlor in respect of a deduction to be claimed for an accounting period is actually made in the accounting period.

If this could not be done, then there would indeed need to be inserted in the trust instrument an overriding provision prohibiting the trustees conferring any benefit which would be treated as "remuneration" within the meaning of section 43(1).

2.4 Finance Act 2003 Schedule 24

The reason that Finance Act 1989 section 43 was emasculated was that the Revenue thought that Finance Act 2003 Schedule 24 did the job much better! In fact, it was easy to circumvent. As a result of various strategies, most of which were, if properly implemented, in my view successful, an amendment was announced on the day of the 2007 Budget Speech. Paragraph 1 of the Schedule as amended by Finance Act 2007 now reads:

> "Restriction of deductions
>
> "1— (1) This Schedule applies if, in calculating for corporation tax purposes[5] the profits of a person ("the employer") for a

5 The corresponding provision in Income Tax (Trading and other Income) Act 2005 was similarly amended. A consideration of the position of non-corporate employers is beyond the scope of this article.

period, a deduction would otherwise be allowable for the period in respect of employee benefit contributions made or to be made (but see paragraph 8).

(2) For the purposes of this Schedule, an "employee benefit contribution" is made if, as a result of any act or omission,

(a) property is held, or may be used, under an employee benefit scheme, or

(b) there is an increase in the total value of property that is so held or may be so used (or a reduction in any liabilities under an employee benefit scheme)."

"Employee benefit scheme" is defined, by paragraph 9(1), to mean "a trust, scheme or other arrangement for the benefit of persons who are, or include, present or former employees of the employer".

It is in my view still possible, by more than one different strategies, for an employer to obtain a deduction for corporation tax purposes for value which is then available in a trust for the benefit of its employees. The amendments have closed down some strategies and opened up others!

While the strategies could take different forms, two types which are viable depend on

(a) ensuring that there is no "employee benefit scheme" or

(b) there is no "employee benefit contribution, as defined.

"Employee benefit scheme" is defined, by paragraph 9(1) to mean (whether or not the context otherwise requires) "a trust, scheme or other arrangement for the benefit of persons who are, or include, present or former employees of the employer".

3 Taxation of the Trust Income and Gains

3.1 Capital Gains

The Revenue normally take the view that a non-UK resident bona fide employee benefit trust is not a "settlement" within the meaning of Taxation of Chargeable Gains Act 1992 section 87. I agree.

The Revenue also normally take that view that a non-UK resident bona fide

employee benefit trust is not a "settlement" within the meaning of Taxation of Chargeable Gains Act 1992 section 86. In my view, that is questionable as a matter of law and could well involve some element of concession. Those who are worried about this could ensure that any "defined person" is excluded from benefit. In the case of an employer which is not a close company, this is usually a matter of ensuring that the trust instrument is properly drafted. In the case of an employer which is a close company, careful attention needs to be paid to Taxation of Chargeable Gains Act 1992 Schedule 5 and in particular to the deemed settlor provisions in paragraph 8.

3.2 Income Tax on Trust Income

Given that the test of "settlement" in Taxation of Chargeable Gains Act 1992 section 87 is the same as in Income Tax (Trading and Other Income) Act 2005 section 620, I would not expect that the Revenue would claim that a bona fide employee benefit trust was a "settlement" within the meaning of the income tax settlement provisions.

It is a moot point whether those provisions apply at all to a settlor within the charge to corporation tax.

Nor do the Transfer of Assets Abroad Provisions apply to corporations. (It is a moot point in what circumstances they can apply to their participators or directors who "procure" the making of a settlement by the corporation.)

If the income has a United Kingdom source, then normally it will be taxed at the same rate as if the trustees were United Kingdom resident.

4 Income Tax on Benefits Received from the Trust: Income tax (Earnings and Pensions) Act 2003 Charges

4.1 A benefit conferred on an employee , even after the employment has ceased, which was an "emolument" would normally be taxable as earnings.

4.2 A Benefit conferred on an employee or his family or in certain cases household could be taxable under the Benefits Code but normally only if the employment was held during the year of assessment in question.

4.3 Even a cash benefit conferred on a person other than an employee would not normally be taxable if the employment in question was not held in the year of assessment.

4.4 Loans to Beneficiaries

Income Tax (Earnings and Pensions) Act 2003 section 174, which is contained in Part 3 Chapter 7 (Taxable benefits: loans) provides:

> "174 Employment-related loans
>
> (1) For the purposes of this Chapter an employment-related loan is a loan—
>
> (a) made to an employee or a relative of an employee, and
>
> (b) of a class described in subsection (2).
>
> (2) For the purposes of this Chapter the classes of employment-related loan are—
>
> A A loan made by the employee's employer.
>
> B A loan made by a company or partnership over which the employee's employer had control.
>
> C A loan made by a company or partnership by which the employer (being a company or partnership) was controlled.
>
> D A loan made by a company or partnership which was controlled by a person by whom the employer (being a company or partnership) was controlled.
>
> E A loan made by a person having a material interest in—
>
> (a) a close company which was the employer, had control over the employer or was controlled by the employer, or
>
> (b) a company or partnership controlling that close company.
>
> (3) ...
>
> (4) References in this section to a loan being made by a person extend to a person who-
>
> (a) assumes the rights and liabilities of the person who originally made the loan, or

(b) arranges, guarantees or in any way facilitates the continuation of a loan already in existence.

(5) A loan is not an employment-related loan if—

(a) ....

(b) it is made to a relative of the employee and the employee derives no benefit from it.[6]

...

(6) For the purposes of this section a person ("X") is a relative of another ("Y") if X is-

(a) Y's spouse or civil partner,

(b) a parent, child or remoter relation in the direct line either of Y or of Y's spouse or civil partner,

(c) a brother or sister of Y or of Y's spouse or civil partner, or

(d) the spouse or civil partner of a person falling within paragraph (b) or (c)."

The trustees of an employee benefit trust might or might not be a person falling within section 174(2). (They might fall within paragraph E of that subsection.)

Can a loan in fact made by the trustees be treated as a loan made by the employer, and thus within paragraph A? Section 173 (Loans to which this Chapter applies) provides:

"(2) In this Chapter-

(a) ...

(b) references to making a loan (and related expressions) include arranging, guaranteeing or in any way facilitating a loan."

The Revenue take the view, in the Employment Income Manual, at 26110 (Meaning of making a loan), that "if a company pays money into a trust fund, and the trustees then make loans to employees, the loans can be treated as if they were made by the

6 Italics added by R.V.

company",[7] on the grounds that the company has "in any way" facilitated the loans to the employees."[8] While it is arguable that an employer who funds a trust "facilitates" a loan made by the trustees only if such is his intention or at least the loan is contemplated by him as a possibility, it would be cautious in the present context to proceed on the basis that the Revenue view is correct.

Thus, a loan made to an employee or a "relative" of an employee[9] would, realistically, be prima facie regarded as an employment related loan under section 174 Income Tax (Earnings and Pensions Act) 2003 and as such will give rise to a taxable benefit in kind on the employee if the rate of interest charged is less than the prevailing Official Rate of Interest under section 181, subject to the exceptions contained in sections 176 to 180.

A loan made to a "relative of an employee" would not, by virtue of section 174(5)(b), be an "employment related loan" if the employee derived no benefit from it. This is question of fact.

Provided that a loan has been made during the employment, the charge can continue to bite (so long as the employee is alive[10]) until the end of the year in which the employment ceases. It will not bite if made at a time after the employment has ceased or for any year during no part of which the employed is employed in the employment. See section 175(2).

If a loan to a "relative" of an employee which has been taxable under section 181 is written off, that would involve a charge to income tax on the employee on the amount written off, by virtue of the curiously worded section 188 (Loan released or written off: amount treated as earnings), which provides:

> "(1) If-
>
> (a) the whole or part of an employment-related loan is released or written off in a tax year, and
>
> (b) at the time when it is released or written off the employee holds the employment in relation to which the loan is an employment-related loan ("employment E"),

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7 See also paragraph 26113.

8 The same reasoning would apply if a loan were made to a "relative" of an employee.

9 Note that this expression (defined in section 174(6), cited above) is both wider and narrower than "a member of the employee#s family" as defined in section 724(4), also cited above. It is also both wider and narrower than the definition of "a member of an employee#s family or household", as defined in section 724(5), also cited above.

10 See section 190.

the amount released or written off is to be treated as earnings from the employment for that year.

(2) But if the employment has terminated or become an excluded employment[11] and there was a time when-

(a) the whole or part of the loan was outstanding,

(b) the employee held the employment, and

(c) it was not an excluded employment,

subsection (1) applies as if the employment had not terminated or become an excluded employment."

There is no charge *under section 188* if the loan was made only after the employment ceased.

If the loan is written off only on the death of the employee, then no income tax liability will arise *under section 188* notwithstanding that the loan was made to a relative who may be still alive. No charge will arise under section 188: see section 190(2) "Section 188 (loan released or written off: amount treated as earnings) does not apply in relation to a release or writing off which takes effect on or after the death of the employee."

A charge under Income Tax (Earnings and Pensions) Act 2003 Part 3 Chapter 10 is precluded by section 202(1)(b).

If a loan is made to a relative of a former employee, either interest bearing or interest free, there would be no charge under Income Tax (Earnings and Pensions) Act 2003 Part 3 Chapter 7 (Taxable benefits: loans).

5 Income Tax on Benefits Received from the Trust: Transfer of Assets Abroad Provisions Charges

5.1 In so far as "relevant income" has arisen within the trust structure, even a capital payment or benefit (not taxable under Income tax (Earnings and Pensions) Act 2003) could result in an income tax charge on a beneficiary ordinarily resident in the United Kingdom at a material time under the Transfer of Assets Abroad Provisions (now contained in Income Tax Act 2007 Part 13 Chapter 2). See Income Tax Act 2007 section 731–735

11 See section 63(4): "In the benefits code "excluded employment" means an employment to which the exclusion in section 216(1) applies."

(formerly Income and Corporation Tax Act 1988 section 740).

5.2 It should also be remembered that even gains which are of a capital nature for trust purposes (e.g. offshore income gains) could constitute "income" for United Kingdom income tax purposes and thus be visited on beneficiaries under the Transfer of Assets Abroad Provisions in the same way as could real trust income.

The potential application of the Transfer of Assets Abroad Provisions is often overlooked in the context of employee benefit trusts. Much can be done to reduce the capricious and unexpected effect of the Provisions by careful drafting.

6 Inheritance Tax: Employer's Concerns

6.1 Contributions to the Employee Benefit Trust

If contributions are made by a "close company", there is an argument that it could make a chargeable transfer of value which could then be apportioned to its participators.

6.2 Extract from the Revenue's Press Release post *Dextra* Decision in the House of Lords[12]

"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

12 Set out in full at Appendix B.

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)."

6.3 Is the Revenue Right?

6.3.1 Inheritance Tax Act 1984 section 12

The effect of Inheritance Tax Act 1984 section 12 (see Appendix C) is that a contribution will not be regarded as a transfer of value provided that it is allowable in computing the company's profits for the purposes of corporation tax. Provided that it is so allowable in the accounting period year in which it is made (or an earlier accounting period) and neither Finance Act 2003 Schedule 24 nor Finance Act 1989 section 43 ("the Corporation Tax Provisions") prevents it being deductible for the period, the position is straightforward. The difficulty arises if either of those sections were to apply to deny deductibility for that period, but, in accordance with whichever section had been operative, a deduction was allowed in a future accounting period.

The problem is that section 12 was enacted before either of the Corporation Tax Provisions and no thought was given to amending it when they were enacted. There are several possibilities. One is that section 12(1) is to be read as if the italicised words had been added:

> "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 or would be so allowable but for the operation of Finance Act 1989 section 43 or Finance Act 2003 Schedule 24."

Another way of reaching the same conclusion, somewhat less clearly, but by the addition of only one word, is to read it as follows:

> "A disposition made by any person is not a transfer of value if it is potentially 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."

On this basis, there would never be a transfer of value as a result of a (potentially) deductible contribution.

A second possibility, at the other extreme, is that if there is no deductibility in the accounting period of payment (or any earlier period), then section 12 does not operate at all. This would obviously be very harsh.

A third theoretical possibility is that section 12 operates on the basis that, if deductibility is prevented by the Corporation Tax provisions, there is an initial transfer of value but that if and to the extent that the contribution later becomes deductible the transfer of value is somehow retrospectively cancelled. The problem with this interpretation is that it is very difficult to square with the wording of the section and one would normally expect there to be provisions for repayment of any Inheritance Tax paid and a general reopening of each participator's history of transfers of value.

A fourth possibility is that section 12 operates on a wait-and-see basis, rather like a potentially exempt transfer. However, this is a very difficult interpretation as one would expect some provisions, similar to those contained in Inheritance Tax Act 1984 section 3A in relation to potentially exempt transfers, spelling out what is to happen in the interval and, perhaps, imposing a time limit.

My own view is that the Courts would be likely to favour the first interpretation, i.e. it is enough if a contribution is potentially deductible. One reason is that this produces a not unfair result. Inheritance Tax is, after all, a tax on gifts and in the circumstances envisaged there will be no gift. The only reason the Corporation Tax provisions apply to delay or deny is deductibility is so that there is some sort of nexus between the deduction obtained by the employer and the charge to tax on the employee.

The second reason is that, even if a contribution does turn out to be deductible in the accounting period in which it is made, this will but rarely be known at the time, whereas section 12 appears to require one to form an immediate conclusion as to whether it applies. The third reason is that there would be no possibility of tax avoidance if this interpretation were to be adopted. However, one cannot be sure that this is the construction which the Courts would favour, or even that the Revenue would accept.

6.4 A Potential Revenue Argument

There is a further difficulty in Inheritance Tax Act 1984 section 12 every applying to a contribution to a discretionary employee benefit trust. This is that the relevant time for Inheritance Tax purposes is the moment the contribution is made and not, if later, the moment the contribution is first recognised as an expense of the employer in its profit and loss account. When section 12 was first enacted, we did not have

the complication of UITF Abstract 32. Hence, in the old days, one could tell as soon as the contribution was made whether it was corporation tax deductible. Now, however, the contribution is unlikely to be so deductible, quite apart from the Corporation Tax Provisions, until something further has happened, such as the making by the trustees of a narrowing-down appointment.

It may thus be very prudent for the trustees to create sub-funds with token amounts for groups of beneficiaries who are likely to benefit and for the employer then to make a contribution directly as an accretion to those sub-funds. This, of course, will avoid the problem only if the trusts of the sub-funds are such as to satisfy the requirements of UITF Abstract 32.

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

7.1 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, 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.

7.2 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."

7.3 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 (1)C 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,

(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.

7.4 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).

7.5 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.

8 Tax-Efficient Gifts By Individuals to Employee Trusts

8.1 General Comment

Gifts by individuals to employee benefit trusts can be remarkable tax-efficient. Moreover, in my view, it is not necessary that employees generally can benefit. A proposed "family" trust can often be made in the form of an employee benefit trust without much practical difference.

However, in my experience, the conditions which need to be satisfied in order to benefit are often misunderstood.

8.2 Inheritance Tax

Inheritance Tax Act 1984 section 28. See Appendix C.

The main features are

(a) the trusts must fall within section 86(1)

(b) the persons for whose benefit the trusts permit the settled property to be applied include all or most of the persons employed by or holding office with the company - i.e. such persons need to be discretionary beneficiaries, but need not necessarily benefit

(c) capital benefits cannot be conferred on certain persons (present or former significant participators and persons who are connected with them at the time of conferral of the benefit

(d) the gift must be of shares in a company of which the trustees have or obtain voting control.

8.3 Capital Gains Tax

Provided Inheritance Tax Act section 28 applies to the disposal, there will normally be no capital gains tax on any gift to the trust, **even if the trustees are non-UK resident**: Taxation of Chargeable Gains Act 1992 section 239. There will be automatic holdover of the gain.

The extent to which this may be useful will depend on the taxation of the trustees and their beneficiaries.

Will Taxation of Chargeable Gains Act 1992 sections 86 or 87 apply to the employee benefit trust?

8.4 Income Tax

Where the settlor is not the employer, it is largely question of fact whether benefits received from the employee benefit trust are taxable as earnings under Income Tax (Earnings and Pension) Act 2003. If they are not in fact a reward for services, but the employee benefit trust is in effect being used simply as a tax-efficient vehicle for private benefit, they should not be.

APPENDIX A: "EARNINGS"

Income Tax (Earnings and Pensions) Act 2003 section 62 (Earnings) provides:

> "(1) This section explains what is meant by "earnings" in the employment income Parts.[13]
>
> (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))."

Income Tax (Earnings and Pensions) Act 2003 section 721 (Other definitions) provides:

> "(7) In the employment income Parts any reference to earnings which is not limited by the context-
>
> (a) to earnings within Chapter 1 of Part 3, or
>
> (b) to any other particular description of earnings,
>
> includes a reference to any amount treated as earnings by any of the provisions mentioned in section 7(5) (meaning of "employment income" etc)."

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13 i.e. parts 2 - 7 (sections 3 - 554) inclusive: see section 3(2).

Income Tax (Earnings and Pensions) Act 2003 section 7 (Meaning of "employment income", "general earnings" and "specific employment income") provides:

> "(1) This section gives the meaning for the purposes of the Tax Acts of "employment income", "general earnings" and "specific employment income".
>
> (2) "Employment income" means-
>
> (a) earnings within Chapter 1 of Part 3,[14]
>
> (b) any amount treated as earnings (see subsection (5)), or
>
> (c) ...
>
> (3) "General earnings" means-
>
> (a) earnings within Chapter 1 of Part
>
> (b) any amount treated as earnings (see subsection (5)),
>
> excluding in each case any exempt income.
>
> (4) ...
>
> (5) Subsection (2)(b) or (3)(b) refers to any amount treated as earnings under-
>
> (a) Chapters 7 and 8 of this Part (application of provisions to agency workers and workers under arrangements made by intermediaries),
>
> (b) Chapters 2 to 11 of Part 3 (the benefits code),
>
> (c) Chapter 12 of Part 3 (payments treated as earnings), or
>
> (d) section 262 of CAA 2001 (balancing charges to be given effect by treating them as earnings).
>
> (6) ..."

In the present context, the most important extension to what is included in "earnings" as a result of section 7 is the inclusion of amounts amount treated as

14 in which section 62 (cited above) is contained.

earnings under Chapters 2 to 11 of Part 3 (the benefits code): see section 7(5)(b). Each of the Chapters of Part 3 contains its own rules. I shall concentrate on the provisions of Chapter 10 (Taxable benefits: residual liability to charge).[15]

Income Tax (Earnings and Pensions) Act 2003 section 201 (Employment-related benefits) provides:

> "(1) This Chapter applies to employment-related benefits.
>
> (2) In this Chapter—
>
> "benefit" means a benefit or facility of any kind;
>
> "employment-related benefit" means a benefit, other than an excluded benefit, which is provided in a tax year-
>
> (a) for an employee, or
>
> (b) for a member of an employee's family or household,
>
> by reason of the employment.
>
> For the definition of "excluded benefit" see section 202.
>
> (3) A benefit provided by an employer is to be regarded as provided by reason of the employment unless-
>
> (a) the employer is an individual, and
>
> (b) the provision is made in the normal course of the employer's domestic, family or personal relationships.
>
> (4) For the purposes of this Chapter it does not matter whether the employment is held at the time when the benefit is provided so long as it is held at some point in the tax year in which the benefit is provided.
>
> (5) References in this Chapter to an employee accordingly include a prospective or former employee."

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15 I also discuss below Chapter 7 (Taxable Benefits: Loans). Other Chapters of Part 3 which might be in point in the present context are Chapter 5 Taxable benefits: living accommodation and Chapter 6 Taxable benefits: cars, vans and related benefits.

The charge to tax under Chapter 10 is to be found in section 203 (Cash equivalent of benefit treated as earnings), which provides:

> "(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.
>
> (2) The cash equivalent of an employment-related benefit is the cost of the benefit less any part of that cost made good by the employee to the persons providing the benefit.
>
> ..."

APPENDIX B: REVENUE PRESS RELEASE POST HOUSE OF LORDS DECISION[16]

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).

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16 R.V. Note: This is couched in terms of the pre-Income Tax (Earnings and Pension) Act 2003 law on which *Dextra* was decided.

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 27th November 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 Hoffmann 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).

APPENDIX C: EXTRACTS FROM INHERITANCE TAX ACT

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.

(2) Without prejudice to subsection (1) above, a disposition made by any person is not a transfer of value if—

(*a*) it is a contribution to a retirement benefits scheme which is approved by the Board for the purposes of Chapter I of Part XIV of the Taxes Act 1988 (occupational pension schemes) and provides benefits in respect of service which is or includes service as an employee (as defined in that Chapter) of that person; or

(*b*) it is made so as to provide—

(i) benefits on or after retirement for a person not connected with him who is or has been in his employ, or

(ii) benefits on or after the death of such a person for his widow or dependants,

and does not result in the recipient receiving benefits which, having regard to their form and amount, are greater than what could be provided under a scheme approved as aforesaid; or

(*c*) it is a contribution under approved personal pension arrangements within the meaning of Chapter IV of Part XIV of the Taxes Act 1988 entered into by an employee of the person making the disposition.

(3) Where a person makes dispositions of the kinds described in more than one paragraph of subsection (2) above in respect of service by the same person, they shall be regarded as satisfying the conditions of that subsection only to the extent to which the benefits they provide do not exceed what could be provided by a disposition of the kind described in any one of those paragraphs.

(4) For the purposes of subsection (2)(*b*) above, the right to occupy a dwelling rent-free or at a rent less than might be expected to be obtained in a transaction at arm's length between persons not connected with each other

shall be regarded as equivalent to a pension at a rate equal to the rent or additional rent that might be expected to be obtained in such a transaction.

(5) Where a disposition satisfies the conditions of the preceding provisions of this section to a limited extent only, so much of it as satisfies them and so much of it as does not satisfy them shall be treated as separate dispositions.

13 Dispositions by close companies for benefit of employees

(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.

28 Employee trusts

(1) A transfer of value made by an individual who is beneficially entitled to shares in a company is an exempt transfer to the extent that the value transferred is attributable to shares in or securities of the company which

become comprised in a settlement if—

(*a*) the trusts of the settlement are of the description specified in section 86(1) below, and

(*b*) the persons for whose benefit the trusts permit the settled property to be applied include all or most of the persons employed by or holding office with the company.

(2) Subsection (1) above shall not apply unless at the date of the transfer, or at a subsequent date not more than one year thereafter, both the following conditions are satisfied, that is to say—

(*a*) the trustees—

(i) hold more than one half of the ordinary shares in the company, and

(ii) have powers of voting on all questions affecting the company as a whole which if exercised would yield a majority of the votes capable of being exercised on them;

and

(*b*) there are no provisions in any agreement or instrument affecting the company's constitution or management or its shares or securities whereby the condition in paragraph (*a*) above can cease to be satisfied without the consent of the trustees.

(3) Where the company has shares or securities of any class giving powers of voting limited to either or both of the following—

(*a*) the question of winding up the company, and

(*b*) any question primarily affecting shares or securities of that class,

the reference in subsection (2)(*a*)(ii) above to all questions affecting the company as a whole shall be read as a reference to all such questions except any in relation to which those powers are capable of being exercised.

(4) Subsection (1) above shall not apply if the trusts permit any of the settled 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 mentioned in subsection (1) above; 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 section 13 above would have been a transfer of value; or

(*c*) any other person who has been a participator in the company mentioned in subsection (1) above or in any such company as is mentioned in paragraph (*b*) above at any time after, or during the ten years before, the transfer of value mentioned in subsection (1) above; or

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

(5) The participators in a company who are referred to in subsection (4) 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.

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

(7) Subsection (5) of section 13 above shall have effect in relation to this section as it has effect in relation to that section.