

## DIRECTOR AND EMPLOYEE REMUNERATION

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### Extracting values from employee benefit trusts

(a) Settling with HMRC

HMRC have offered to settle past cases on the basis that a past income tax charge on the employee, with interest, was incurred on payment into the trust. A deduction for corporation tax purposes is also then given. The cost will outweigh the corporation tax deductibility. Take-up rate for this offer has not been high.

Relevant considerations:

- (i) The taxpayer may already have a good case for deduction (see the recent *Scotts Atlantic Management Ltd* case on FA 2003 Schedule 24 (decision date 13 May 2013) and note the complete stop on progress with cases where the EBT was funded by means of a declaration of trust by the employer company.
- (ii) No case has so far supported HMRC's contention that the payment into the EBT was earnings of the employee and several indicate the contrary. Note that the *Rangers* case is going to appeal in 2014.
- (iii) If the EBT contributions have grown in value since contribution, the growth is not taxed as income. This sometimes makes the HMRC settlement worthwhile.

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(b) Selling assets to an EBT

Selling assets to the trust or buying them from an EBT are encouraged by section 554Z8 ITEPA 2003 (reduction for consideration given for ‘relevant step’) .Note the oddities in the tax avoidance test in this section which is one-way only. Consider selling “lock- up” assets to the EBT, for example, shareholdings in private companies from which it is unlikely benefits will be extracted. If the sale is on arm’s length terms with no benefit, there should be no chargeable relevant step. This solution should work even where there has been no earmarking if there is no benefit.

(c) Extracting benefits in other ways

Where the EBT trustees are connected with the employee, consider the trustees acquiring an asset which is made available to the employee as his property in return for a promise by him to contribute a sum of money to the EBT in 20 years’ time. It is considered that this falls within section 554 Z8 which specifically mentions consideration provided by a person linked with the employee. This protects against a disguised remuneration charge.

The questions which arise are:

1. Is there an earnings charge? It is thought that this could be avoided if the employer has already obliged itself to contribute.
2. Is there a benefit in kind charge under the residual charge or under the free loans provisions? These are not considered to apply – see *Mairs v Haughey* [1993] STC 569 in which ‘making good’ a benefit was satisfied by an obligation to pay at a later date. Consider whether it is worth creating a small charge under the disguised remuneration rules in order to avoid the charge on credit. That appears to be the effect of section 554 Z2 ITEPA 2003.
3. Consider whether the new section 464A Corporation Tax Act 2010 applies (charge to tax on company: arrangements conferring benefit on participator)? Even if it does the charge is only on the amount of the benefit. That could be very small if the quantum of the contribution increases year by year.
4. A further issue is whether the GAAR reverse the advantages under sections 554 Z8 and 554 Z2. There is certainly a difficulty in re-characterizing the transaction under the GAAR.

## **Living with employee benefit trusts**

The alternative to extracting value is to live with the EBT. Note that enjoying benefits from EBTs is not per se a relevant step. Licences and short leases of property are specifically exempted. Licences over a whole range of assets are not dealt with. Loans are to be avoided at all costs (and old loans should be indefinitely extended). EBTs can be used as unapproved pension schemes. This is positively encouraged.

## **Adapting the EBT for the self-employed**

The secret of EBT planning was to obtain a deduction for the contribution in and avoid paying out funds absolutely. Why not consider a trust for self-employed persons - an SEBT? Take LLP1 which consists of self-employed individuals. Some of those individuals along perhaps with one or two senior employees form LLP2 which supplies services to LLP1. LLP1 rewards those services with a flat rate payment plus a top-up payment. The top-up payment is discretionary and is in fact paid into an SEBT for the members of LLP2. They can extract benefits from the trust. The points which arise are:

- (1) Is there a transfer of a right to income? Not normally.
- (2) Is the payment received by the SEBT income? Not in the writer's view.
- (3) Is there a settlement for income tax purposes? If this is the case, the consequences are that only income arising from contributions is caught.
- (4) Is the arrangement caught by sections 773-789 ITA 2007 (sales of occupation income)? Not if the activity pursued by LLP2 is a trade. NB even where LLP1 pursues a profession or vocation, LLP2's activities may be a trade.
- (5) Are benefits from the SEBT taxable? Not in the writer's view.
- (6) Is the arrangement caught by the GAAR? One way to reduce the risk of the GAAR applying is to keep the commercial features in the arrangement. LLP2 may offer strategic advice i.e. which genuinely increases profits.

## **EBTs operating LLPs or companies**

A fertile source of interesting structures can be devised using funds in an EBT. If cash is left in an EBT, what happens where that cash is employed in an LLP of which the EBT's beneficiaries and others are members?

Suppose that the business concerned derives profit principally from the provision of services but members have considerable amounts of capital tied up in it. Before the EBT joins, members take out the bulk of their capital using a short term bank loan. This is tax neutral. The EBT using discretionary un-earmarked funds contributes capital and is entitled to a share of profits. While the tax on those profits is taxed highly at the trust rate, the injection of capital for a share of profits does not, it is thought, give rise to a relevant step under section 554 C ITEPA 2003. The transaction could be re-arranged, if it is thought there was a risk, to reduce it. This might involve a winding up of old LLP with capital being extracted plus the formation of a new LLP to which the EBT trustees subscribe capital. Note, it is much easier to shelter profits in an EBT by sideways relief than it is with individuals.

It may be asked whether the profit shares from the new LLP accruing to partners who could benefit from the EBT are caught by the disguised remuneration provisions. It is thought that they are not if the arrangement represents a fair balance. What the EBT earns clearly swells the trustees' funds and if relevant steps are carried out, liability will arise. However, the profits accruing to the individual members represent a reward for their efforts and are not part of any "relevant arrangement" to reward them as employees.