

CHAPTER 21

EMPLOYEE BENEFIT TRUSTS

21.1 What is an Employee Benefit Trust (EBT)?

An EBT is a trust set up by an employer for the benefit of employees (including directors) and their spouses and dependants.

An EBT is funded by contributions by either the employer or by individuals such as shareholders. Contributions can be in the form of shares in the employer company, or cash or other property.

The EBT will hold or invest the assets to produce income and gains. The EBT Trustees will thereafter make distributions to the beneficiaries. Cash payments to employees out of the EBT will be liable to income tax and national insurance contributions. PAYE should be operated on such payments.

Where non-cash benefits (e.g. low interest loans) are made available to an employee, such benefits are liable to income tax and Class 1A (Employer's) NIC.

21.2 Inheritance tax and EBTs - general introduction

An EBT is essentially a **discretionary trust**. Therefore, in the absence of special rules, **transfers into the trust are chargeable transfers** and the trust is subject to **exit and principal charges**.

However, if certain conditions are satisfied, **exemptions apply to the creation of employee trusts**:

- 1) by close companies; or
- 2) by individuals.

We will cover these below. We will also consider the IHT position on the transfer of property out of an EBT.

21.3 S.86 IHTA 1984

Special inheritance tax treatment is given to EBTs provided that S.86 IHTA 1984 is satisfied.

[IHTA 1984, s. 86](#)

S.86 applies where property is held on trust for the benefit of:

- a) **persons employed** in a particular trade or profession; or
- b) **employees or directors** of a body carrying on a trade; or
- c) **spouses, civil partners, relatives or descendants** of a) or b) above.

In the case of employees, spouses and relatives at b) and c) above, S.86 applies either if **all or most of the employees or directors are included as beneficiaries** of the EBT, or if the EBT is an approved share ownership plan (eg, a SIP).

21.4 Close companies - dispositions for benefit of employees

We will now consider the IHT advantages offered to EBTs falling within S.86, starting with EBTs set up by close companies.

Under S.94 IHTA 1984, a transfer of value made by a close company can be **apportioned back to the participators** (shareholders) of the company. The amounts then apportioned are treated as chargeable lifetime transfers made by the shareholders.

[IHTA 1984,
s. 94](#)

To the extent that the chargeable transfer exceeds annual exemptions and the available nil rate band, tax is payable at 20/80. The **company is primarily liable for the tax** although the transfer will form part of the shareholders' cumulative "clock".

However, under S.13(1) IHTA 1984 **a disposition by a close company to an EBT is exempt from IHT** provided that the gifted property is held on trust for the **benefit of employees in accordance with S.86**. Such a disposition is not a lifetime transfer of value (and is not therefore apportioned back to shareholders) if the beneficiaries of the trust include **all or most** of either:

[IHTA 1984,
s. 13\(1\)](#)

- the employees / directors of the close company; or
- the employees / directors of any subsidiaries of the close company.

S.13(2) disappplies S.13(1) in circumstances where an EBT is set up by a close company and the Trustees permit the trust property to be applied for the benefit of:

[IHTA 1984,
s. 13\(2\)](#)

- a) a **shareholder**; or
- b) any person connected with a shareholder; or
- c) any person who has been a shareholder in the **previous 10 years**.

Therefore EBTs set up for the benefit of shareholders or other connected persons, will not benefit from the special IHT treatment. **IHT liabilities will therefore arise on both creation and on any subsequent distributions** from the EBT.

A "shareholder" in this context means a person entitled to **at least 5%** of the issued share capital or the company's assets in the event of a winding-up.

[IHTA 1984,
s. 13\(3\)](#)

A "connected person" is defined very widely and will include relatives, in-laws, aunts & uncles and nieces & nephews.

[IHTA 1984,
s. 270](#)

This means that **where a shareholder** (or his relatives) **can benefit from the trust**, the transfer to the EBT by the close company will be a **transfer of value and will be apportioned back to the shareholder**.

There is an exception in S.13(4) which says that S.13(2) will not be applied in cases where the Trustees permit **cash payments to be made to a shareholder which are chargeable to income tax** in his hands. This will be the case where the shareholder is also an employee because payments from EBTs to employees are taxed as employment income.

[IHTA 1984,
s. 13\(4\)](#)

In this case, there is no transfer of value on the transfer to the EBT.

HMRC take the view that where the trust deed seems to exclude the shareholders from benefit but **nevertheless the shareholders do benefit**, for example:

- by them taking a **loan** from the EBT; or
- by assigning funds from the EBT on sub-trusts for their benefit or for the benefit of their family,

an IHT charge arises under s.94 because the funds have been applied for the benefit of the shareholders.

It remains in dispute whether a loan from the EBT at fully commercial terms and at a rate of interest in excess of the HMRC official rate is, in fact, a "benefit".

21.5 Transfers to EBTs by individuals

Under S.28 IHTA 1984, a **transfer by an individual to an EBT is an exempt transfer** for IHT subject to the following conditions:

[IHTA 1984,
s. 28](#)

- a) the property transferred **must be shares in the employer company**;
- b) the beneficiaries of the trust must be **all or most of the employees** and directors of the company;
- c) within one year of the transfer, the **Trustees must own more than 50% of the ordinary shares** of the company and have majority voting rights; and
- d) the trust does not permit any of the property to be applied for the benefit of:
 - a shareholder; or
 - any person connected with a shareholder; or
 - any person who has been a shareholder in the previous 10 years.

A "shareholder" in this context means a person entitled to at least 5% of the issued share capital or the company's assets in the event of a winding-up.

A "connected person" will include relatives, in-laws, aunts & uncles and nieces & nephews.

As with transfers by close companies there is an exception where the Trustees permit **cash payments to be made to a shareholder which are chargeable to income tax** in his hands. Therefore if the shareholder is also an employee the payment from the EBT will be taxed as employment income. In this case there is no transfer of value on the transfer to the EBT.

[IHTA 1984,
s. 28\(6\)](#)

If **S.28 does not apply, there is no IHT exemption**. Therefore the transfer to the trust will be a chargeable lifetime transfer.

21.6 S.12 IHTA 1984

S.12 IHTA provides potential relief for contributions by individuals or close companies to EBTs which would otherwise be treated as chargeable transfers.

[IHTA 1984,
s. 12](#)

Under S.12, a disposition by any person (individual or company) is **not treated as a transfer of value** for IHT if that payment is **allowable in computing that person's profits for income tax or corporation tax purposes**.

Therefore, assume a close company makes a transfer to an EBT under which either the shareholders or persons connected with the shareholders can benefit. In this case, the transfer would not be ignored as S.13(2) would deny the exemption. The transfer by the close company would then be **chargeable to IHT and would be apportioned back to the shareholders**.

However, if the payment would be **deductible in calculating the company's profits for corporation tax purposes**, the transfer by the close company is **disregarded for IHT** by virtue of S.12.

In practice, a claim under S.12 can often be difficult to achieve as a result of the introduction of Sch 24 FA 2003 (now S.1290-1296 CTA 2009). For corporation tax purposes, a contribution to an EBT is **allowable in the year in which payments are made to (or benefits are received by) the employee**. Therefore no corporation tax deduction is usually given in the year in which the contribution to the EBT is made.

As the contribution made by the close company to the EBT is **not deductible in the year of the payment**, HMRC take the view that this denies any relief under S.12. If there is no relief under S.12, the transfer to the EBT by the close company for the benefit of its shareholders will be chargeable to IHT.

There is no provision to treat the close company disposition as a transfer of value for IHT in the year of payment, and then repay any IHT in the year in which the corporation tax deduction is achieved.

21.7 S.10 IHTA 1984

Under S.10 IHTA, contributions to EBTs are disregarded for IHT purposes in circumstances where it could be argued that the **transferor did not intend to confer a gratuitous benefit** on the trustees.

[IHTA 1984,
s. 10](#)

The argument in favour of a S.10 claim is that payments are made at arms-length to the EBT purely for the purposes of remunerating the employees. This is a commercial decision undertaken in the normal course of business.

HMRC's view is that, by its very nature, an EBT is a discretionary trust. Therefore to satisfy the conditions of S.86, the trustees must have **unfettered discretion over the trust assets**.

Therefore, as the employer cannot be sure how the trustees will exercise their discretion, it is by no means certain that payments will be made to employees by way of "remuneration". As such, **there must be some gratuitous intent by whoever makes a contribution to the trust**. Therefore the S.10 defence will be denied. This is an on-going issue.

21.8 Business Property Relief

If an **individual transfers shares to an EBT** and S.28 is not satisfied (for example, control of the company does not pass to the Trustees or the trust is for the benefit of the shareholders), then a chargeable transfer will arise.

[IHTA 1984,
s. 105](#)

This transfer may be eligible for BPR. This will be the case if the shares transferred to the EBT are **unlisted shares in a trading company** which have been held for **at least 2 years**.

21.9 Distributions of property from an EBT

Where the EBT satisfies S.86:

- 1) there is (usually) **no exit charge on a distribution** from the trust; and
- 2) there is **no principal charge** on the 10-year anniversary.

The following situations **will** cause there to be an exit charge on an appointment from an EBT;

[IHTA 1984,
s. 72](#)

- 1) Where property ceases to be held on a qualifying employee trust other than via a distribution of the trust property. This may be the case if the trust starts as an EBT but at some point thereafter **ceases to be an EBT** and instead becomes (say) a non-employee trust;
- 2) Where a payment is made to a person (or to a person connected with him) **who has provided any of the trust property** by amounts exceeding £1,000 in any tax year. Essentially there is a charge on contributors ("settlers") to the trust who subsequently receive a benefit;

- 3) Where the employment is with a **close company**, and a **shareholder receives a payment** ("shareholder" in this context meaning someone owning 5% or more of the share capital or assets on a winding-up);
- 4) Where the trustees make a disposition (otherwise than by way of a payment out of trust property) as a result of which the **value of trust property is reduced**. Such a "disposition" could include a failure to exercise a right or any other omission which causes a loss to the trust.

In the case of 4) above, HMRC accept that no charge arises if the trustees did not intend to confer gratuitous benefit on the transferee.

Note: where a distribution is made from an EBT to a shareholder who is also an employee, there will be a **charge to income tax on the distribution**. In this case **there will not be an exit charge**.

21.10 Capital gains tax issues

A transfer of shares by either an individual or by a close company to an EBT will be a **disposal for CGT purposes**.

Under basic principles, the **transfer will be deemed to have taken place at market value** as it will not be a "bargain at arms length". Assuming that the market value of the assets transferred exceeds the CGT base cost, the **disposal will give rise to a chargeable gain** in the hands of the transferor.

[TCGA 1992, s. 17](#)

However, S.239 TCGA 1992 applies to disposals to trustees of employee trusts. Under S.239 (subject to certain conditions), the **transaction will not be deemed to have been carried out at market value**. Instead:

[TCGA 1992, s. 239](#)

- 1) if the transferor sells the shares to the trustees at a price above his CGT base cost, any **gain will be limited to the actual gain realised**;
- 2) if the transfer is a gift for no consideration or a sale for a price below the CGT base cost, the transfer is treated as taking place at "**no gain no loss**".

This relief is automatic and does not require a claim.

The key conditions of S.239 are that the **disposal should be an exempt transfer** for the purposes of either:

- a) S.13 IHTA 1984 (in the case of a transfer of shares by a close company);
or
- b) S.28 IHTA 1984 (in the case of a transfer of shares by an individual).

Remember that to secure IHT exemption, the beneficiaries of the EBT must be the employees of the company as opposed to the shareholders or their families.

If a gain arises on a transfer to an EBT, **then gift relief might be available.** Gift relief may be claimed under S.165 TCGA 1992 where the transferor is an individual and the shares gifted are either:

[TCGA 1992,
s. 165\(2\)](#)

- i. in an unlisted trading company; or
- ii. in a personal trading company.

Gift relief is restricted where the company holds investment assets or where there is a sale at undervalue and the proceeds received exceed the CGT base cost.

[TCGA 1992,
s. 165\(7\)](#)

Gift relief is not available if the transferor can benefit from the EBT.

[TCGA 1992,
s. 169B](#)