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Introduction to Employee Benefit Trusts (EBTs)

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Over the last 20 years, EBTs have been a phenomenon of UK business. EBTs have regularly been used in an idealistic way: to forge an almost romantic union between employees and the business for which they work. Frequently, however, the use of EBTs has been a furtive torrid affair, with tax advantages exploited to the full. The UK Inland Revenue adopted the role of investigative journalist, tracking down such uses and, in the style of the English tabloids, has dramatised real and perceived abuses of EBTs. Self regulation had failed and so in 2003, alongside other changes, the UK Government introduced anti-avoidance legislation to moderate the tax benefits[1]. The legislation overrides case law and there is a genuine concern that benign uses of EBTs have been discouraged.

What is meant by an EBT?

What is meant by an EBT is a subject in its own right: there is a cornucopia of acronyms and other expressions to work through (AESOP, APS, APSS, case law EBT, ESOP, ESOT, NAESOP, PST, QUEST, SIP and so on). In broad terms, an EBT is a trust established for the benefit of the employees of a company or group of companies. Typically, the trust is a discretionary trust. The trust deed will provide that the employees of the relevant company or companies are beneficiaries and will prohibit the application of trust property other than for the benefit of such employees and, possibly, former employees and charities. In this way, an EBT will be exempt from the usual UK inheritance tax ("IHT") regime that applies to discretionary trusts. If the EBT holds shares in a company it can provide the company's employees with a voice and a stake in the business for which they work. The key requirement to obtain these IHT reliefs is that "all or most" employees are eligible to benefit from the trust[2]. This is consistent with achieving employee participation and ownership objectives on a democratic basis. It also provides what can be seen as a smokescreen for favouring the few tax efficiently. As with other discretionary trusts, it is for the trustees to decide who, from the class of beneficiaries, benefits when and to what extent. This flexibility makes it difficult for the Inland Revenue to work out, merely from looking at the trust deed, how exactly an EBT will be used.

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1 Finance Act 2003, Schedule 24 (Restriction of deductions for employee benefit contributions).

2 Section 86 Inheritance Tax Act 1984.

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Background to EBTs

20 years ago the UK had a line of reported cases dealing with the tax treatment of contributions by companies to EBTs[3] but EBTs were not mainstream. Few tax and trust practitioners and UK businesses had technical or practical knowledge of EBTs. Practitioners who dealt with EBTs were uncertain as to whether or not cash contributions to an EBT would give a revenue deduction for the contributing business. A case reported in 1987 helped the case for tax deductions[4]. This case highlighted, in particular, the scope for an EBT to provide a tax efficient succession solution for the owners of family businesses. The cost of acquiring shares in a trading company from retiring shareholders via an EBT could, with care, be set against trading profits. There was publicity for the use of EBTs in employee ownership and participation structures[5]. This use of EBTs was not new flagship: examples of employee trust controlled companies such as the Scott-Bader Commonwealth and John Lewis Partnership already existed. But a new generation of semi-philanthropic business owners (e.g. Philip Baxendale at Baxi Partnership) and lobbying organisations such as JOL, the voice of UK employee-owned business, gave new momentum to these uses of EBTs.

Other commercial uses of EBTs became firmly established. UK-quoted companies, under investor guidelines, have a limit on the number of new shares that may be used for employees' share schemes. EBTs provide a method of acquiring shares in the market and warehousing these for use in employees' share schemes without breaching the limits on issuing new shares. As knowledge of EBTs spread, so did their use for tax planning purposes.

Prior to 1987, EBTs were used to pay cash bonuses without national insurance contributions ("NICs"). Incredible as it seems today, until 5 October 1987, regulations excluded from NICs any payments made to employees by trustees where the amount paid was at the trustees' discretion. What would normally be paid out as cash bonuses by a company were, instead, paid out free of NICs through EBTs.

Successful lobbying led to the creation of a statutory form of employee trust known as a qualifying employee share ownership trust (or QUEST)[6]. A company contributing to a QUEST could, in particular, obtain a tax deduction for its contributions by statute, rather than relying on case law. EBTs that had to rely on case law deductions became known as case law EBTs. QUESTs became very popular as a method of getting tax relief for the costs of issuing shares for Inland Revenue approved savings related share option schemes. The tax savings were significant and this became seen as an abuse of the legislation. There were other uses made of QUESTs which were clearly not in keeping with the original policy objectives.

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3 See *IR v Parsons* [1928], *CIR v Fitte* [1943], *Heather v P-E Consulting Group Ltd* [1972], *Brumby v Milner* [1976], *Rutter v Charles Sharpe & Co Ltd* [1979], *Jeffs v Ringtons Ltd* [1985].

4 E Bott Ltd v Price [1987].

5 eg. *Employee Ownership Legal and Tax Aspects* by John Nelson-Jones and Graeme Nuttall (Format Publishing 1987).

6 Finance Act 1989 Sections 67-74 and Schedule 5.

Corporation tax relief for contributions to a QUEST was withdrawn for accounting periods beginning on or after 1 January 2003.

Offshore EBTs

The Inland Revenue's attention also focussed on offshore EBTs. There is nothing in the IHT definition of an EBT that means an EBT has to be established on-shore. An EBT with non-UK tax resident trustees can operate outside the scope of UK capital gains tax and still benefit from IHT relief. City bonuses, instead of getting paid directly to executives, subject to income tax and NICs, would get paid to an offshore EBT. Employers would argue for a corporation tax deduction based on case law and yet there would be no corresponding tax charge on the executives. By leaving untaxed bonuses in an EBT, executives could, in effect, benefit from an offshore roll-up fund. Schedule 24 to the Finance Act 2003 introduced new legislation to regulate when an employer gets a tax deduction for contributions to an EBT. The new rules align the timing of tax deductions with the time employees receive taxed remuneration. These rules apply widely to any "employee benefit contribution" to an "employee benefit scheme". The latter definition includes any trust, scheme or other arrangement for the benefit of persons who are, or include, employees of the employer. There are limited exceptions.

The Inland Revenue has confirmed that this new anti-avoidance legislation is intended to block tax deductible contributions to buy shares, which are then held indefinitely within an EBT, even if this is part of a genuine employee ownership arrangement.

Recent developments

There have been recent changes in UK tax legislation that help promote employee share ownership such as the new corporation tax relief for employee share acquisitions[7]. The UK Government also provided support to a Private Member's Bill which introduced a limited form of up-front tax deduction for contributions to a particular type of employee trust[8]. UK Government policy and EU research does, however, focus on getting shares directly into the hands of employees. By way of a concluding comment to this article, I question whether this emphasis is right.

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7 Schedule 23 Finance Act 2003.

8 Employee Share Schemes Act 2002 which related to share incentive plan trusts (see now, in particular, paragraph 9 of Schedule 4AA to Taxes Act 1988).

Is this emphasis right?

The author's view is that EBTs are a vital part of operating employees' share schemes in most UK private companies. Gordon Brown, UK Chancellor of the Exchequer, is on record as stating that he wants "to double the number of firms in which all employees have the opportunity to own shares"[9]. Arguably, the new anti-avoidance legislation goes too far and

9 Pre-Budget Report November 1998.

some adjustments are needed if the Chancellor is to achieve and maintain his stated aim. If the UK Government and other Member States are to achieve productivity gains by increasing employee equity participation they need to learn from the success stories of businesses owned by EBTs and their equivalents in other jurisdictions.

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