

Article topic: Tax Planning

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Employee Benefit Trusts – a creative and highly tax efficient solution

In the current economic climate companies are looking for more creative ways to reward and incentivise key directors and staff, as well as the business owners themselves. Increasingly, clients are opting for Employee Benefit Trusts (EBTs), which are a highly tax efficient alternative to bonuses, or other methods of profit extraction.

What is an EBT?

An EBT is a trust set up by a business for the benefit of employees and their families. This can include current, prospective and former employees and directors. The employer makes contributions to the EBT, possibly as an alternative to paying bonuses. The Trustees of the EBT then have wide discretion as to how, when and to whom contributions are allocated, to suit the needs of the business, or the employee's personal circumstances. An EBT can be set up as a UK trust, but is more typically located offshore. Until funds are paid out, the EBT Trustees have extensive powers to invest the trust capital in a wide range of investments or assets and, if located offshore, the value may roll-up tax-free. EBTs bring a range of potential benefits to employees. This bulletin looks at the particular advantages of flexible loans.

EBT loans – a cash bonus alternative

- The EBT can make loans to the employee on a low or interest-free basis. This could be instead of a bonus on which they may pay Income tax and NIC charges of 41% (51% for high earners from April 2010).
- Loans can be on flexible terms, or at the discretion of the trustees, perhaps allowing for repayment after a fixed term, or when employment ends. Ultimately, loans could continue indefinitely, well beyond the retirement of the employee, or even their death.
- Outstanding loans that are made at less than the UK official rate of interest (currently 4.75%), will incur a benefit-in-kind charge based on the interest rate differential. Employees paying tax at 40% will incur an effective 1.9% per annum tax charge on monies received. The employer will incur a charge to NIC equating to 0.61% per year, which after corporation tax relief, would cost the employer only 0.44% per annum.
- The annual benefit in kind charge will continue to apply until the employment ceases. Post-employment, interest-free loans fall outside the benefit in kind legislation, so the annual tax charges cease to apply and the employee can retain use of the money on a tax-free basis.



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- If the loan made to the employee remains in place at the date of death, the liability will be treated as a debt on the estate for Inheritance Tax purposes – reducing Inheritance Tax by up to 40%.
- Following death, the Trustees have wide discretion as to how to deal with the outstanding loan, such as allowing it to be waived, relent, or appointed out to the deceased's family.

Example: EBT vs bonus or dividend

The table below shows the net cash received by an employee/shareholder if £100,000 of profit is extracted by way of bonus, dividend, or EBT loan.

	Bonus	Dividend	EBT Loan
Pre-tax profit	£100,000	£100,000	£100,000
Company tax / NIC	(£11,348)	(£28,000)	(£28,000)
Individual tax + NIC	(£36,347)	(£18,000)	(£0)
Net cash to individual	£52,305	£54,000	£72,000
Annual benefit in kind of EBT loan	-	-	£1,368

Therefore, by taking an EBT Loan rather than a bonus or dividend, the employee can receive additional cash funds of up to £19,695. This rises to £28,560 for a higher rate taxpayer after April 2010.

Other tax benefits

Close company loans

Closely controlled companies can effectively make loans to shareholders, or their families, through an EBT without incurring the 25% corporation tax charge that would arise if the company made the loans directly.

Nil Income Tax or NIC contributions

There are no Income tax or NIC charges when funds are contributed to the EBT. The Trustees are free to notionally allocate the funds, or create sub-trusts for specific employees and their families.

Tax free roll-up of EBT funds

Income and capital gains made within an EBT can roll-up tax free where the EBT is located offshore and invests in non-UK based assets. Where the EBT is located onshore, the Trustees will be liable to Income tax at 40% and 32.5% on dividend income (rising to 50% and 42.5% from April 2010).

Inheritance Tax shelter

Assets held within an EBT are outside UK Inheritance Tax laws as the trust qualifies as a tax favoured 'employee trust'. This includes the trust 10-year principal and exit charges. Where the employee has taken an EBT loan, the liability will also potentially reduce their estate subject to IHT on death.



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Tax efficient for employees

Payments of cash from the trust to employees will be liable to Income tax and NIC in the normal way. Similarly benefit in kind provisions apply where the employee obtains non-cash benefits and remains in employment. However, the benefit in kind rules cease to apply when the employment ends, and payments, or loans from the trust to an employee's family following death can be made tax efficiently.

Tax relief for contributions

Employer contributions are tax deductible, but only when matching payments are made to employees as taxable emoluments. Where the employee takes a loan instead of emoluments, then the timing of any deduction will be deferred.

Other benefits of an EBT

An EBT can be used to provide an array of benefits to employees, including:

- Payment of discretionary bonuses, e.g. linked to performance, or continuing service.
- Provision of shares or share options - possibly under an employer sponsored scheme.
- Flexible loans to employees, or their immediate family (these can be on an interest-free basis as noted above).
- Holiday homes for use by employees, or their families.
- Other non-contractual benefits, e.g. life, or health insurance, staff parties and annual holidays.
- A 'market maker' to allow employees to buy and sell shares in the company.
- Lump sum payments following death, or retirement.

EBTs in summary...

EBTs are an attractive tax efficient structure for incentivising, rewarding and motivating employees. They are well understood and accepted by HMRC and advisors alike, having a valid commercial purpose for the modern business. They can also provide significant tax and cashflow benefits from a tax planning perspective. For example, the ability to provide interest-free loans at a tax cost of only 1.9% per annum. This is very appealing for high earners, particularly where a 50% tax rate will apply after April 2010.

For more information on the benefits of EBTs, please speak to our Tax Planning team.

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