

Information

EMPLOYEE BENEFIT TRUSTS

1. An Overview

An employee benefit trust (EBT) is a means of providing rewards and incentives for staff, and attracting new staff to a company, for the benefit of the business of the company. It can hold cash and other assets of any kind including shares in the company itself. This allows it to provide a market in the shares for outgoing shareholders; and also to satisfy share options granted by the company under any share scheme.

The EBT is established by the company, and is a separate legal entity from the company. The EBT is usually funded by donations from the company. Once funds are made over to the EBT the company has no continuing legal or beneficial interest in or control over them. The trustees, who are independent of the company, are the legal owners of the trust fund and have complete discretion as to how it is used to benefit the beneficiaries of the EBT, subject to their overriding fiduciary duties as trustees.

The beneficiaries are the present and past employees of the company and its subsidiaries, and their families and dependants. From this group the trustees will decide which beneficiaries are to receive benefits, and the amount of those benefits. The trustees may consult with the employer company, and may make different levels of benefit available to different employees. Benefits can be made available to them in various forms including

outright payments of cash or other assets; loans; making assets available for their use; and generally as the trustees decide. Certain persons are excluded from benefiting from the EBT in any circumstances, namely, the company itself, any shareholder or group of shareholders who uses his or their control to procure the transfer of assets by the Company to the EBT, and their spouses, anyone who has added property to the EBT, and anyone whose inclusion as a beneficiary would prevent the EBT qualifying for exemption from inheritance tax 10 yearly and exit charges (i.e. anyone who is not an employee or former employee, or related to or dependent on an employee or former employee at the company or any of its subsidiaries). For inheritance tax reasons participators holding 5% or more of the shares in the company may also be excluded.

The EBT can be established as a UK resident or non-UK resident trust. It can be more tax effective for the trust to be non-UK resident.

2. **The Trustees**

The EBT is established under a trust deed granted by the company. The initial trustees are an independent professional trustee company which is non UK resident. Turcan Connell, through its Guernsey office, is able to provide offshore trust management services. The company has power to appoint other trustees and may also remove a trustee. Where a sub-fund has been created and separate trustees of the sub-fund have been appointed, the company's power to remove trustees can be restricted or terminated entirely.

The trustees are entitled to be paid for their services. Trustees who provide professional services to the trust (for example legal or accounting services) are entitled to be paid at the usual rate for those services.

The trustees have complete discretion in exercising the powers given to them under the EBT and may, though are not obliged, to consult with the company and/or its remuneration committee.

The trustees are not liable for any loss to the trust fund unless it is caused by their own fraud. The trustees are not jointly liable, and each is liable for his own actions only. The trustees are entitled to rely on advice given to them by properly appointed advisers; and are not liable for anything they may have done in accordance with recommendations by the company.

The company gives an indemnity to the initial trustees and all future trustees against any costs they may incur as a result of acting as trustees of the EBT. The indemnity does not extend to costs arising as a result of the trustees' fraud, willful misconduct or gross negligence.

3. **The Beneficiaries**

The beneficiaries of the EBT are

- present and past employees and directors of the company and its subsidiaries;
- the spouses, widows and widowers of such employees and directors;
- the children of such employees and directors;
- the dependants of such employees and directors.

The company may invite its subsidiaries to participate and make contributions to EBT.

4. **The Benefits**

The trustees are given wide discretion in deciding the amount and timing of payments from the trust, and in selecting which of the beneficiaries are to receive payments. They are entitled to consult with the company but the final decision will be theirs.

The trustees may make outright payments in the form of cash or assets; they may make assets available for the use of the beneficiaries; they may make loans on favourable terms; and generally they may provide benefits in whatever form they think appropriate. Employees and their families are taxable on outright payments of money or transfers of assets from the trust. It is more tax efficient for the employee to take loans from the trust and be given the use of an asset. The employee will then suffer a benefit in kind charge on 5% of the value of the asset, rather than on the whole amount. The most tax efficient way of structuring benefits can be tailored for each individual case.

The trustees may also transfer assets to any other qualifying employee benefits trust; grant share options to beneficiaries and transfer shares in satisfaction of share options that have been exercised. The trustees are given wide powers of investment and administration of the trust funds.

The trustees can pay out income or capital. If they wish they can accumulate any income arising in the trust and add it to the capital and can do so for 21 years from the date the trust is set up.

The trustees may earmark specific funds for particular employees and their families within the EBT, thereby creating "sub-funds". This may be done on a revocable or irrevocable basis. If done on an irrevocable basis, that particular fund would then be permanently held for the benefit of that employee and family. A separate set of trustees may be appointed to administer and hold such a sub-fund.

5. **Funding the Trust**

The EBT will often be established with an initial cash contribution from the company and further cash contributions may be made on a regular basis. In deciding on the amount that may be contributed, the company should take advice from its accountants, bearing in mind the rules governing deductibility for corporation tax.

6. **Taxation & Accounting Treatment of EBT**

Income Tax and Capital Gains

The trustees are subject to the normal rules for taxation of trust income and capital gains. They are subject to tax at 40% on income and gains arising in the trust. If the trust is non UK resident, the trustees are not liable to United Kingdom capital gains tax on disposals. Exceptionally, if the trustees dispose of assets used for the purposes of a trade carried on in the United Kingdom, they would be subject to capital gains tax on any gains arising. Non-resident trustees are subject to income tax on United Kingdom source income.

It is understood to be the Inland Revenue's current view that the rules which imposes capital gains tax beneficiaries of offshore trusts who receive payments from such trusts do not apply to employee benefit trusts established by companies as part of their remuneration strategy.

Inheritance Tax

Discretionary trusts are subject to an inheritance tax charge on every tenth anniversary of the setting up of the trust and also when property leaves the trust. These charges do not apply to trusts for the benefit of employees which meet the conditions in section 86 of the Inheritance Tax Act 1984. The trust must be for the benefit of all or most of the persons employed by the company. The families of employees may also be beneficiaries.

Where a close company makes a contribution to a trust for the benefit of its employees, the shareholders in the close company may suffer an inheritance tax charge. This charge does not apply in certain circumstances, including

- where the contribution to the trust is allowable as a deduction in calculating the company's profits for corporation tax;
- where participators in the company who own 5% or more of the company's issued share capital are excluded from benefit under the trust. This also extends to anyone who has been a 5% + participator during the ten years before the date on which the contribution was made to the trust and anyone connected with such a participator.
- Where the arrangement between the Company and the trust is on arm's length commercial terms.

Corporation Tax

A corporation tax deduction for contributions to the EBT is deferred until a payment is made out of the EBT in a form that gives rise to a liability to income tax and national insurance. This does not affect companies contributing to an EBT that qualifies for relief under the statutory corporation tax deduction for employee share schemes. Advice should be taken from the company's tax advisers on whether the envisaged benefits will qualify for a corporation tax deduction.

Accounting

Although the trust is a separate entity from the company, for accounting purposes the trust assets may in some circumstances require to be recognized in the company's balance sheet. This treatment ceases to apply when a beneficiary acquires a vested interest in the trust assets. It is also understood that the requirement to consolidate does not apply where funds have been irrevocably earmarked for specific beneficiaries and their family; and also where the trust acts as a "warehouse" for the company's shares. However this is a matter for specialist accounting advice.

7. **Company Law**

The EBT requires the approval of the board of directors of the company. Approval should be confirmed by a formal board minute recording the reasons why the trust has been set up.

The trust deed must fall within the definition in section 743 Companies Act 1985 to avoid being subject to the prohibition on companies providing financial assistance for the acquisition of their own shares. Where the trust holds shares in the company the beneficiaries are deemed to have an interest in the shares and this requires the duty of disclosure in section 324 Companies Act 1985 to be complied with. This imposes a duty on a director to disclose shareholdings in his own company.

8. **Employment Law**

The company should announce the establishment of the EBT to its employees. It must be made clear that there is no contractual right on the part of any employee to benefit from the EBT and that the payment of benefits remains entirely at the discretion of the trustees. It should also be made clear that the EBT is independent of the company and does not form part of the company's contractual arrangements with the employee, nor is the company under any obligation to fund or continue to fund the EBT.

9. **Death of Beneficiary**

The EBT would continue even if one or more directors/shareholders/beneficiaries were to die. If a sub fund had been created for an employee, it would remain in existence after his death for the benefit of his family.

An individual beneficiary would not normally have any fixed right under the EBT which could be bequeathed to someone else on his death. However, a beneficiary may like to put his wishes in writing to the trustees for their guidance in the event of his death. The written guidance is not binding on the trustees but unless there are strong reasons to the contrary, they would normally regard it as persuasive.

Provided the EBT for the deceased employee's sub fund is held on discretionary trusts at the time of death there will be no inheritance tax to pay on it.

10. **Liquidation of Company**

The EBT is legally independent of the company. The assets of the EBT do not form part of the assets of the company and are not available to meet claims by its creditors. As the EBT is for the benefit of employees and former employees as well as their families, there is no reason in principle why the EBT cannot continue for the benefit of former employees in the event of the company being wound up. The fact that the company ceases to exist does not prevent the EBT continuing. The company has the power to appoint and remove trustees. If the company ceased to exist, this power would cease to apply and the trustees themselves would then decide on the appointment of any new trustees.

One practical issue is that the company would no longer be able to consult with the trustees about the payment of benefits. However, there is no reason why the trustees could not continue to consult with the former shareholders and directors on these issues. It may be that in those circumstances, the company would expect the EBT to be wound up and that could be written into any guidelines prepared for the benefit of the trustees at the outset. As these guidelines are not legally binding, they can be altered at any time.

11. **Sale of Company**

As the EBT is independent from the company, a change in ownership of the company would not affect control of the EBT which would remain under the control of the trustees. Depending on the structure of the sale, the company may acquire new employees, including management level employees, who could then become beneficiaries of the EBT with the potential to benefit under it.

There is a good deal of flexibility within the trust deed to allow the trustees to cater for this situation and they can consult with those involved at the time. Among the options open to the trustees are to wind the trust up and distribute to the "pre-sale" beneficiaries (although this would result in the beneficiaries suffering a tax charge); to "ring fence" the trust fund at the date of the sale for the beneficiaries at that time, with any new employees only being able to benefit from the contributions made after the sale; to create different funds for different classes of employees; to create a new separate trust for the "pre-sale" employee which would hold the fund at that time, with the main trust continuing for all employees who could only benefit from future contributions.

On the whole it is preferable to leave flexibility in dealing with these situations rather than building in automatic termination or other provisions, as they can sometimes produce undesirable legal or tax results.

If you would like to discuss the issues involved in setting up, funding and running an Employee Benefit Trust, please contact Heather Thompson or Donald Simpson at Turcan Connell, Edinburgh (ht@turcanconnell.com or ds@turcanconnell.com).

This note is intended as a brief summary of the taxation and legal position of Employee Benefit Trusts as at August 2005. No responsibility can be accepted for any action taken in reliance of this note and specialist advice should be taken in every case. Turcan Connell would be happy to provide such advice.

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