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EMPLOYEE BENEFIT TRUSTS AND SECTION 13 IHTA 1984

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The recent budget press releases contained a statement that the Government is to take action to tackle avoidance through the use of trusts to reward employees (PN03). That statement is a reflection of a current hostility to the use of employee benefit trusts.

Nevertheless, as much as HMRC has sought to tackle perceived abuses in the *MacDonald (Inspector of Taxes) v Dextra Accessories Ltd* [2005] STC 1103 and *Sempra Metals Ltd v HMRC* [2008] STC (SCD) 1062 cases as well as the legislation at sections 1288 to 1297 CTA 2009, it is worth reflecting that much of the UK tax code actively encourages the use of such trusts.

Unfortunately, the current HMRC approach seems to be at odds with that legislation. In particular many of the views set out in *Revenue & Customs Brief 61/09 Inheritance Tax on contributions to Employee Benefit Trusts* ("Brief 61/09") represent an attack on the use of employee benefit trusts which is unsustainable when considered in the context of the clear words of the legislation.

Section 13 IHTA 1984

Section 13 IHTA 1984 *Dispositions by close companies for benefit of employees* is one of a number of provisions which actively encourages employers to create employee benefit trusts. It does so be providing that dispositions by close companies to employee benefit trusts satisfying certain criteria should not be a transfer of value. The conditions of that section are also echoed in section 239 TCGA 1992 *Disposals to trustees of employee trusts*

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which offers relief on gifts of assets to a qualifying trust.

The importance of this inheritance tax relief has been magnified following the decision in *Dextra* and the introduction of Schedule 24 FA 2003 (now contained in sections 1290 to 1297 CTA 2009). It is now clear that a transfer to a employee benefit trust will not normally be allowable as a deduction in computing profits for corporation tax purposes even where it is clearly for the purposes of the company's trade. In the context of a close company (which for these purposes includes a company which would be close if UK resident: section 102(1) IHTA 1984) this is important as transfers of value by the company can be apportioned to participators in that company with a resultant charge to inheritance tax on them.

If a transfer to a trust is not deductible for corporation tax purposes then (in the absence of a purposive construction to take account of the possibly unintended consequences of sections 1290 to 1297 CTA 2009) section 94(2)(a) IHTA 1984 cannot apply to prevents an apportionment and/or section 12 IHTA 1984 cannot apply to prevent there being a transfer of value. Certainly, this is the view expressed in Brief 61/09

It may be possible to rely on other provisions such as section 10 IHTA 1984 *Dispositions not intended to confer gratuitous benefit* (see for example the decision of the Special Commissioners in *Postlethwaite's Executors V HMRC* [2007] STC (SCD) 83). Nevertheless, the position would seem to be clearest in relation to that provision which squarely aimed at offering relief for transfers by close companies to employee benefit trusts, namely section 13 IHTA 1984.

The HMRC view

In this context, the hard line stance adopted by HMRC in Brief 61/09 is somewhat alarming. While it is difficult not to take issue with much of what is said in Brief 61/09 (the comments on sections 10 and 86 IHTA 1984 bear re-examination in light of the statutory wording and relevant case law but are beyond the scope of this article) the analysis of section 13 IHTA 1984 is perhaps most alarming given the level to which it appears to conflict with the clear words of the statute.

The brief starts its comments on section 13 IHTA 1984 by stating that:

> *"The effect of s13 is that an Inheritance Tax charge arises under s94 on contributions to an Employee Benefit Trust made by a close company where:*
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> - *the contribution is to an Employee Benefit Trust which satisfies s86*
> - *the participators (as defined in s102(1)) in that company and any*

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person connected with them are not excluded from benefit under the terms of the Employee Benefit Trust (so that s13(2) disapplies s13(1)) and

- *the contributions are not allowable in computing the company's profits for Corporation Tax purposes (s12) and/or it is not shown for the purposes of s10 that the contributions are made in arms-length transactions not intended to confer a gratuitous benefit".*

It is difficult to make much sense of this when one has regard to the relevant section. Firstly, section 13 IHTA 1984 is a relieving provision (*"A disposition of property made to trustees by a close company whereby the property is to be held on trusts of the description specified in section 86(1) below is not a transfer of value if …"*) so it never has the effect that a charge arises under section 94 IHTA 1984.

Secondly, although subsection (2) does require participators and certain other person to be restricted from benefitting, it is not the case that they must be excluded from benefitting. That restriction is qualified by subsections (3) and (4) and the definition of participator in section 207 IHTA 1984. The qualification in subsection (3) relates to participators with less than 5% interests while the definition of participator excludes loan creditor participators. The qualification in subsection (4) (considered in more detail below) expressly envisages that participators can benefit under the trust to a limited extent. Brief 61/09 makes no reference to such qualifications.

Thirdly, it is irrelevant to the application of section 13 IHTA 1984 whether any other relief applies, although obviously the availability of other reliefs will restrict the relevance of the section 13 IHTA 1984 relief.

The necessary restrictions

It is clear from section 13(1) IHTA 1984 that in order to satisfy the conditions of the relief, the trust must at the date of the disposition satisfy the conditions of section 86(1) IHTA 1984 (property may not be applied otherwise than for the benefit of a class defined by reference to employment and persons defined by reference to marriage, relationship or dependence on the employee class) and furthermore that the trusts permit property to be applied for all of the employees of the company.

It is also clear from subsection (2) that any person who, at the date of such disposition either: is a participator in any company which makes a disposition to the trust; was a participator in any such company in the ten years before the disposition; or who becomes a

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participator at any time after the disposition ("restricted beneficiaries") are to be restricted in the manner in which they benefit. Additionally, insofar and for so long as any person is connected with a restricted beneficiary, then they also will be a restricted beneficiary

The permitted benefits

To that extent, Brief 61/09 is unobjectionable. What is objectionable is that as stated above this restriction is expressly subject to two let outs. References to participators in the definition of restricted beneficiaries do not include participators with less than 5% interests (subsection (3)) in the company and subsection (4) states that:

> *"(4) In determining whether the trusts permit property to be applied as mentioned in subsection (2) above, no account shall be taken-*
>
> > *(a) of any power to make a payment which is the income of any person for any of the purposes of income tax, or would be the income for any of those purposes of a person not resident in the United Kingdom if he were so resident, or*
> >
> > *..."*

The effect of this subsection is that in very clear terms it is not necessary to exclude participators (and persons connected with them) from benefitting under a settlement in order for a transfer to that settlement to qualify for relief under section 13 IHTA 1984. It will of course be necessary to restrict the manner in which such beneficiaries can benefit, which may require careful drafting, but the view set forth in Business Brief 61/09 is clearly contradicted by the express terms of the section. Restricted beneficiaries *can* benefit under the settlement *provided that* any benefit is a payment which is income for the purposes of income tax.

While it is not suggested that in setting out such an erroneous view in Brief 61/09 HMRC are deliberately trying to mislead taxpayers and their advisors (although they have) the alternative view (that the author of Brief 91/06 simply didn't understand how section 13 IHTA 1984 operates) is hardly much less worrying.

Payment which is the income of any person

The level of benefits which can be provided to restricted beneficiaries consistently with the application of section 13 IHTA 1984 is actually relatively wide. A payment of cash out of an employee benefit trust is an emolument and would therefore be permitted under section

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13(4) IHTA 1984 as being a payment which is the income of a person for the purposes of income tax (*Brumby (Inspector of Taxes) v Milner* [1976] STC 534 and section 17 ITEPA 2003).

Further, where a beneficiary is benefitted in a manner such that the benefits code in Chapters 2 to 11 of Part 3 ITEPA 2003 applies (as it often will in any event) then that benefit is employment income (section 7(2) and (5) ITEPA 2003). As such, it is income of a person for the purposes of income tax.

Although there is not an actual payment as required by section 13(4)IHTA 1984, it would require an extremely literal approach to the section to suggest that such a benefit falls outside the scope of subsection (4). It is suggested that any modern Court would adopt a purposive approach to the meaning of 'payment' in this context.

In any event, it is suggested that the deeming of a benefit to be earnings and income must also requires that the deemed income is treated as having been paid. This is consistent with the proper approach to construing deeming provisions as noted by Lord Browne Wilkinson in *Marshall v Kerr* [1994] STC 638 (confirming Peter Gibson J on the point in the court below):

> *"one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, unless prohibited from doing so."*

If a benefit is treated as earnings, the consequences and incidents following from that are that they are also treated as paid. Accordingly provided that a benefit from an employee benefit trust comes within the benefits code such as to give rise to a charge to income tax, it is suggested that it will be permitted under the terms of the restriction in section 13(4) IHTA 1984.

It is not clear why this treatment should be considered necessarily objectionable. On the basis that the company in question has not obtained a corporation tax deduction, there will be no timing discrepancy (such as what was at issue in *Dextra* and *Sempra*). Further, there is no question of a participator obtaining an income tax free benefit. To the extent that employees might obtain such an advantage, that is clearly within the policy of the section.

Payments in breach of trust

A final point relates to the view expressed in Business Brief 61/09 that:

> *"Where the trust deed specifically purports to exclude the participators from benefit but nevertheless the participators do benefit in fact for example:*
>
> - *by payment to them of loans or*
> - *by assigning funds from the Employee Benefit Trust on sub-trusts for their benefit and that of their family*
>
> *Then HMRC take the view that s13(2) disapplies s13(1) and the Inheritance Tax charge under s94 arises because the funds have been applied for the benefit of the participators".*

Firstly, it is worth noting that there is long standing authority that a loan on commercial terms is not inconsistent with a provision of a settlement excluding the beneficiary of the loan from benefit. Such a loan is not a benefit at all. As was noted by Lord Reid in *Lord Vestey's Executors v CIR* 31 TC 1 at 121

> *"I find it impossible to hold that a sum of money lent at a commercial rate of interest is "payable to or applicable for the benefit of" the borrower in the sense of this Section".*

Where the loan is at less than a commercial rate of interest, then it is suggested that since the benefit of that loan is treated as earnings (see *Employment Income Manual* at 26110), it could come within section 13(4) IHTA 1984. On that basis, the objection once again is less clear.

It may be that this paragraph is drafted on the assumption of a complete exclusion from benefit, but even that raises difficulties. As regards the appointment of sub-funds for the benefit of a participators family, it is noted that as connected persons, such members of the participators family will also be restricted beneficiaries. On this basis, presumably the greater objection is not the appointment of sub-funds, but their inclusion as beneficiaries at all.

As regards the appointment of sub-funds generally (and whether this is permitted under subsection (4)) it is suggested that HMRC at least have a tenable argument (although not one with which the author agrees) and as such there can be no objection to their putting forth their views on such argument. What is objectionable is putting forth views that are on no reasonable analysis of the legislation sustainable.

A final point relates the suggestion by HMRC that payments in breach of trust after a disposition can affect the treatment of that disposition. This seems unfair, but it would still

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seem to be an open question whether payments made in breach of trust can cause the conditions of subsection (2) to be breached (see *Venables v Hornby* [2004] STC 84 where a similar question was left open by the House of Lords). Once again, the author's view is that it cannot (section 13 IHTA 1984 is directed at what the trust in question permits) but arguments to contrary would at least seem to be tenable.

Conclusion

Brief 61/09 is poorly drafted and many of the point which it puts forward, particularly in regard to the application of section 13 IHTA 1984 are either nonsensical or unsustainable. The Brief should be withdrawn and proper guidance issued on the application of the section,