Business Tax Update

July 2010

Turning on the Spotlight

"The British tend to shy away from the spotlight. We don't like being singled out in any way..." Damon Hill

The introduction of the 50% “supertax” for those with income over £150,000 is focusing the minds of many high-earning taxpayers on ways of mitigating their tax liabilities. Indeed taxpayers are looking at increasingly exotic methods of saving tax, a trend that is being accelerated by restrictions imposed on tax relief for pension contributions.

HMRC has responded to this increased tax avoidance activity by issuing so called “Spotlights”. In HMRC’s own words, Spotlights are “all about tax avoidance”, and they are intended to “help taxpayers understand” what HMRC are likely to view as tax avoidance, and identify the types of schemes or arrangements that they are likely to challenge. Two Spotlights of particular note are:

- Spotlight 5, which focuses on planning using Employee Benefit Trusts (“EBTs”); and
- Spotlight 6, which considers the use of Employer Financed Retirement Benefit Schemes (“EFRBS”)

In both cases, these vehicles are being used by individuals to extract cash from a company tax efficiently by seeking to obtain a tax deduction for a payment made by the company, whilst deferring (or even avoiding) an Income Tax charge arising on the funds received by the individuals.

Since there are specific tax rules governing how both EBTs and EFRBS are treated for tax purposes, what is the mischief that HMRC are looking to throw the spotlight onto? This is perhaps best explained by looking at HMRC’s comments in each Spotlight, and explaining the specific planning they are aimed at.

EBT Planning

In Spotlight 5, HMRC refer to arrangements aimed at rewarding employees without operating PAYE and NIC. HMRC are referring to a typical scenario where a company wishes to reward its senior employees. To do so by way of an ordinary bonus payment would attract both PAYE (at up to 50%) and Employer’s and Employee’s NIC (at 12.8% and 1% respectively), although the company would obtain a Corporation Tax deduction for the bonus payments. As an alternative strategy, some companies establish an EBT and then contribute funds to the EBT. In certain cases the company may even claim a Corporation Tax deduction for the contribution.

The funds may then be allocated to individual EBT sub-funds for the benefit of specific employees and their families. Employees may then access these funds by means of, for example, loans from their sub-funds. These loans would be subject to the usual benefit in kind rules, so employees would generally pay interest to the EBT at the “official rate” (currently 4.75%) in order to avoid a benefit in kind charge arising. However, paying interest is usually regarded as an acceptable cost, as this merely increases the amounts available to lend back to the employee by their individual sub-fund.

Even if, as is often the case, the EBT is set up offshore, the tax cost of the EBT loan would be limited to the 20% withholding tax employees would be required to deduct before paying interest over to their sub-fund. This equates to an effective annual tax rate of just under 1%, which would generally be seen as an acceptable tax cost. This can be even further reduced depending on the jurisdiction in which the EBT is located. Furthermore, the amounts held in the sub-fund are outside the employee’s estate for Inheritance Tax (“IHT”) purposes.

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From HMRC's perspective, Spotlight 5 advises taxpayers that, in their view, these amounts are subject to PAYE and NIC once they have been allocated to the sub-funds. There may also be an IHT charge based on the value of the contribution made by the company, unless the shareholder employees who control the company are excluded from benefit.

However, many prominent commentators disagree with HMRC's view, and consider that the law supports the taxpayers' contention that the amount of the EBT loans is not subject to PAYE. Provided the terms of the loan are commercial, and it is not open-ended (ie there is an expectation of repayment following a future event or passage of time, and it is not a "loan for life") then the view is that case law supports the contention that these payments cannot be re-characterised as remuneration when they are in fact loans.

Accordingly, many tax advisers and taxpayers consider that EBT loan structures are successful in extracting funds into the hands of individuals without triggering a PAYE liability. In addition, HMRC's statement in the June 2010 Budget that they would legislate against EBT structures used in this way in April 2011 would seem to acknowledge this, albeit implicitly. Otherwise there would seem to be little point in legislating against a structure that does not achieve the tax savings taxpayers expect.

EFRBS

In Spotlight 6, HMRC focus on the use of EFRBS by employers who claim a Corporation Tax deduction for contributions on the basis that the payment is a "qualifying benefit" under the EFRBS provisions. In this case, HMRC are referring to arrangements which seek to provide employees with benefits "on, or in connection with," retirement under the specific EFRBS rules.

Typically the company would create an EFRBS and contribute cash for the benefit of employees and their families. Under the EFRBS provisions, there is no Income Tax charge on employees for contributions to an EFRBS, and they are also free from National Insurance contributions. The assets in the EFRBS will also be outside the employee's estate for IHT purposes. In addition, if the EFRBS is set up offshore then only UK source income will be taxable, and there will be no UK tax liability on any capital gains.

One further advantage is that the typical £20,000 annual allowance for pension contributions qualifying for higher rate tax relief does not apply to an EFRBS. This means there is no limit on the amount of contributions that can be made to an EFRBS. Consequently, EFRBS are attractive to executives who have already paid maximum contributions to a conventional pension scheme.

In some instances, companies have claimed a Corporation Tax deduction for a contribution to an EFRBS on the basis that this contribution, or a transfer to a second EFRBS, represents a "qualifying benefit" under the terms of the legislation. However, HMRC have stated in the Spotlight that, in their view, this is not correct, and will therefore seek to deny a deduction claimed in these circumstances.

Generally where an employee takes benefits out of an EFRBS, which could be by way of lump sum, pension or annuity, there is an Income Tax charge. There is also a potential IHT charge if the EFRBS is used to provide death in service benefits. Payment to an EFRBS therefore represents an Income Tax deferral for the employee, perhaps to a time when they are either non-UK resident, or are paying tax at a lower rate.

However, in a similar way to EBTs, some EFRBS will lend the funds to employees on normal commercial terms, so that they can access the funds within the EFRBS immediately, without waiting to take benefits on retirement. Again, HMRC's view is that these amounts are subject to PAYE and NIC once they have been allocated to the sub-funds. There may also be an IHT charge based on the value of the contribution made by the company, unless the shareholder employees who control the company are excluded from benefit. Similarly, many prominent commentators disagree with HMRC's view, and consider that the law supports the taxpayers' contention that the amount of the EBT loans is not subject to PAYE, as noted above.

Conclusion

It is understandable that HMRC are keen to advise taxpayers about tax planning which they consider is unacceptable, and it is helpful that they issue these Spotlights to indicate areas of particular concern. However, it should be remembered that HMRC's view of what constitutes tax avoidance is not always accepted by the Courts. In addition, HMRC's announcement in the June 2010 Budget that they intend to further legislate against EBT and EFRBS structures from 6 April 2011 implies that HMRC recognises these structures may successfully avoid tax at present.

If you are interested in any of the issues raised in this Business Tax Update, please speak to your usual Rawlinson & Hunter contact to discuss how we may assist you.

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