

Insight: Global Equity-based Compensation

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Impact of new legislation on the taxation of EBTs and EFRBs

Following a period of speculation after the budgets earlier this year, the UK Government yesterday released draft legislation intended to challenge arrangements involving the use of trusts and other vehicles to defer or avoid the payment of income tax or national insurance contributions ("NICs"). This will affect the use of employee benefit trusts (and, in particular, the use of sub-funds) ("EBTs") and unregistered pension schemes known as Employer Financed Retirement Benefit Schemes ("EFRBs").

What will the effect of the new legislation be on the payment of income tax for EBTs and EFRBs?

The effect of the new legislation will be to tackle the avoidance or deferral of income tax by causing employees to face an income tax charge as soon as a third party (such as a trustee) makes a reward, payment, or loan or earmarks a sum or asset in connection with the employee's current, future or former employment through an EBT or similar trust vehicle. The sum or value of the asset will be considered as employment income, with employers liable to withhold and account for income tax under PAYE.

In the case of EFRBs, is there a possibility of double taxation?

The legislation would reverse the original treatment of EFRBs, whereby contributions were not subject to income tax until benefits were paid to the relevant beneficiary. Under the proposed legislation, it is understood that contributions will be taxed on payment into the trust and, on a distribution, on any subsequent increase in value. However, there are provisions in the draft legislation intended to ensure that any amounts which have been previously subject to income tax will not be taxed again.

How will income tax for EBTs/EFRBs be calculated?

Income tax will be payable through PAYE at the employee's marginal rate on the full amount of the reward, payment or loan and for assets that have been transferred or made available for the employee's use, the higher of their cost or market value.

Will NICs be payable?

Both employees and employers will also be liable for NICs at the usual rates on the amount treated as employment income.



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When will the legislation take effect?

The new legislation (and resulting tax liabilities) will apply to all rewards, payments, and loans that have been earmarked or made available for the benefit of an employee, or former or prospective employee on or after 6 April 2011. Where a payment or loan is made, or an asset is provided, between 9 December 2010 and 5 April 2011, and would have been caught under the legislation if it had been paid or provided on or after 6 April 2011, anti-forestalling provisions will apply.

The anti-forestalling provisions mean that the new legislation will have immediate effect as they will act to capture any rewards, payments or loans that are earmarked or made between 9 December 2010 and 5 April 2011.

How will the anti-forestalling charges work?

A charge to income tax will apply to any rewards, payments, or loans that are earmarked or made between 9 December 2010 and 5 April 2011 and will arise on 6 April 2012 where employees have not repaid sums or surrendered readily convertible assets (such as listed shares) before that date. The sum or value of the assets will be treated as a payment of employment income made on 6 April 2012 and subject to income tax under PAYE. Any sums that have been repaid will be deducted when calculating the employment income.

When will income tax be payable?

In relation to income tax charges arising on any relevant sums, assets, or loans which are made or earmarked on or after 6 April 2011, payment will be effected via PAYE.

What are the exemptions from the new legislation?

Certain arrangements are excluded from the new legislation, including:

- registered pension schemes;
- approved employee share schemes and Enterprise Management Incentive arrangements;
- ordinary commercial transactions, including loans on ordinary commercial terms; and
- benefits packages that are made genuinely available to substantially all employees and that cannot only be accessed by select employees (notably senior executives).

Is there still a future for EBTs and EFRBs?

It is evident that the new legislation will significantly impair the effectiveness of trust based arrangements as vehicles geared towards income tax deferral. Employers will need to review their existing trust arrangements to ensure that future liabilities to PAYE income tax and NICs are identified and appropriate measures taken for such liabilities to be discharged.