Employee benefit trusts and inheritance tax: bursting the bubble

Employment Tax | Large Corporate | Inheritance tax and trusts

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Employee benefit trusts remain a valuable share plan tool, but advisers should review their structure and operation to identify potential inheritance tax risks.

Key Points

What is the issue?
Inheritance tax is becoming a much more important consideration for employee benefit trusts, particularly following the restriction of business property relief. Although qualifying EBTs can benefit from relief, inheritance tax charges can still arise in a range of situations.

What does it mean to me?
Existing EBTs may need to be reviewed to ensure that relief remains available and

that historic arrangements have not created inheritance tax exposure.

What can I take away?
Inheritance tax should now be part of routine EBT governance. Practitioners should review trust structures, beneficiary provisions and historic arrangements to identify potential inheritance tax risks before HMRC does.

‘If you need to think about inheritance tax in an employee benefit trust, something’s probably gone wrong’ – or so I might have said a few years ago. Unfortunately, for many share plan practitioners, this is no longer the case.

In the absence of relief, inheritance tax can arise on contributions to discretionary trusts (by individuals or close companies), on the ten-year anniversary of the trust’s establishment, and on the transfer of assets out of a trust. Employee benefit trusts (EBTs) are a form of discretionary trust and, while an exemption from inheritance tax will often be available, this is by no means always the case. Many EBTs may have escaped an inheritance tax charge through luck rather than judgement.

The reduction of 100% business property relief from 6 April this year (to a maximum of 50% for Alternative Investment Market (AIM) and private company shares above a £2.5 million threshold) means that inheritance tax has become relevant in many more scenarios.

What is an employee benefit trust?

Almost all EBTs are intended to fall within the definition in Inheritance Tax Act (IHTA) 1984 s 86 (a ‘qualifying EBT’): they are trusts for the benefit of all or most of the employees and directors of a company, plus ex-employees and certain family members. A qualifying EBT is exempt from the inheritance tax charges that would otherwise arise at a rate of up to 6% every ten years on the value of assets held in a discretionary trust.

EBTs are a useful vehicle for employee share plans, often used to warehouse shares for future awards. For private companies, they can also provide a market for shares held by employees, allowing value to be realised in the absence of an exit.

One point I want to make upfront is that, while EBTs continue to be a common and uncontroversial tool for employee share plans, historically they have been key components of a number of tax avoidance schemes. This no longer works. However, while such EBT schemes have almost all now been settled from an income tax, NI and corporate tax perspective, many EBT settlements excluded inheritance tax. The deadline for HMRC to raise an enquiry into inheritance tax where no return has been filed is 20 years, with no need to show fraud or carelessness.

Although not the focus of this article, I will also touch on historical arrangements for which an inheritance tax liability may nonetheless still be a very live issue.

Setting up an EBT

Falling within IHTA 1984 s 86 is a good start, but for ‘close’ companies, inheritance tax may still be charged on any contribution to an EBT under IHTA 1984 s 94. The company is liable for the tax, but the rate is calculated as if each ‘participator’ in the company (broadly, shareholders and loan creditors) had made a chargeable lifetime transfer as an individual. This is presumably intended to prevent family businesses from using an EBT as a vehicle to avoid inheritance tax.

The first thing to be cautious about is that it is not always easy to tell whether a company is ‘close’. The definition of a close company is one controlled by five or fewer participators, but the holding of a participator is aggregated with that of their associates for this purpose. A company owned by another company will be ‘close’ if the parent is close, even if the parent is not itself subject to UK tax. It may be difficult to show that, for example, a complex private equity fund structure is not ultimately controlled by a small number of individuals. There is no size limit: a fully listed PLC may be ‘close’ if controlled by a founder.

The key exemption from the IHTA 1984 s 94 charge on funding an EBT is set out in IHTA 1984 s 13, which exempts a gift to an EBT provided the EBT excludes all 5%+ participators from any benefit. For this purpose, the 5% threshold applies to any single class of shares, often catching out employee share plans that use special classes of shares.

Before 30 October 2024, it was possible to benefit such participators in a form subject to income tax, but if they represent more than 25% of employees, they must from that date be excluded altogether. This can be a significant obstacle to using an

EBT for an investment fund where many employees are also partners in a partnership, and thereby ‘associated’. Care should therefore be taken to ensure that the conditions of s 13 are met, especially if an older EBT established before October 2024 is being used for a new round of awards.

Assets leaving an EBT

There is a specific inheritance tax charge on assets leaving a qualifying EBT, set out in IHTA 1984 s 72. This is somewhat misleadingly known as the ‘flat rate’ charge. It is charged at a cumulative rate based on the number of quarters for which assets have been in trust, starting at 0.25% per quarter for the first 40 quarters and gradually increasing to a maximum of 30% after a full 50 years.

The key exemption here is found in s 70(3)(b), applied to EBTs by s 72(5). No tax is due on a disposition that is income of any person for tax purposes, or would be if that person were resident in the UK. In practice, *almost* all dispositions for the benefit of a specific beneficiary of an EBT will be subject to income tax. If not under any other legislation, they will generally be taxed by virtue of the disguised remuneration legislation in Income Tax (Earnings and Pensions) Act (ITEPA) 2003 Part 7A, which was enacted specifically to tax benefits provided through third-party structures such as EBTs.

So where does the qualification ‘almost’ arise?

We most commonly see this in relation to historical EBTs, where a PAYE settlement has been entered into on the basis that income tax arose on, for example, the making of a loan to an employee. This can then lead to a subsequent charge under s 72 on the release of the loan because of the timing mismatch, notwithstanding that, in real terms, this amounts to double taxation of the same value.

Our experience is that HMRC takes a very strict approach to timing here and, if the income tax charge does not arise at the same time as the disposition giving rise to inheritance tax, it will treat inheritance tax as due.

Turning to current arrangements, it is not uncommon for a discounted option to be granted to an employee over shares held in an EBT. This would not generally trigger an immediate income tax charge. Although HMRC confirms in its guidance that it will not generally seek to charge inheritance tax on the grant of an option, it may be

preferable for such grants to be made by the employer company itself, with a corresponding linking agreement requiring the EBT to satisfy awards on exercise, so that there is no ‘disposition’ by the EBT before the exercise date.

At times, we see companies seek to reduce surplus assets in EBTs through, for example, a share buyback for nominal value. If the company has the legal right to force a buyback as a condition of funding the EBT to acquire the shares in the first place, this is arguably consistent with the trustee’s duties. Otherwise, there is a more fundamental trust law issue that should be addressed before the tax position, since it is difficult to see how the trustee is acting for the benefit of employees rather than the company in such a case.

Regardless of the trust law position, however, such arrangements clearly fall within the scope of s 72 and, without business property relief to come to the rescue, are likely to be subject to inheritance tax.

Assets held in trust

An EBT will almost always be intended to fall within IHTA 1984 s 86, but this does not mean it will qualify in practice.

Firstly, it is possible for s 86 relief to be lost. This may happen, for example, where a trust is established for the benefit of a specific category of employees, who later cease to represent ‘most’ of the employees of the company. Care should be taken to track which employees are actually within the class of beneficiaries of an EBT, particularly following a transaction or group restructuring.

Secondly, it is HMRC’s view that, where assets are held within a sub-trust of a trust that would otherwise qualify under s 86, the sub-trust should be treated as a separate trust unless its beneficiaries include all or most employees. On that basis, the sub-trust would not satisfy the requirements of s 86. This can lead to:

- an ‘exit charge’ under IHTA 1984 s 72 on the transfer of assets from the main EBT to the sub-trust;
- ten-year charges on capital assets held within the sub-trust; and
- exit charges of up to 6% under IHTA 1984 s 65 on assets leaving the sub-trust.

We rarely see sub-trusts today, but they were once a common tax planning structure. The case of *Rangers* [2017] UKSC 45 provides a well-known example. Since sub-trusts were not generally expected to fall outside s 86 when they were established, EBT trustees may not have retained the detailed records needed to calculate inheritance tax charges on the assets concerned. Calculating the inheritance tax due can therefore be extremely difficult, particularly because the ten-year charge runs from the date on which assets were first settled on trust, rather than the date they entered the sub-trust.

It is, however, worth working through the detail of the trust assets if this issue arises, since the ten-year anniversary charge is only due on capital assets and on income that arose more than five years ago. Before 6 April 2014, the charge applied only to capital assets, with assets that were income in nature excluded altogether.

'Income' in this context includes any assets derived from income where they have not been accumulated to capital by the trustees. As a result, assets that do not appear to be income on their face may nonetheless be income in nature for inheritance tax purposes. This can remove a considerable portion of the assets from the inheritance tax calculation, although the quid pro quo is that they will then be subject to income tax in the hands of beneficiaries on distribution.

If all else fails…

Two final pieces of case law are worth noting: *JTC v Garnett* [2024] EWHC 3128, in which EBT sub-trusts were rescinded; and *Bhaur* [2023] EWCA Civ 534, in which rescission of an EBT was refused.

In most cases, little can be achieved by holding assets in a sub-trust that could not instead have been achieved, without triggering inheritance tax concerns, by the trustee informally earmarking assets. In *JTC v Garnett*, the trustees succeeded in an application to rescind the sub-trusts, thereby restoring the protection of IHTA 1984 s 86. This is not the same as simply revoking the sub-trusts and required an application to the court. The cost of such an application may be disproportionate for many trusts, but is clearly worth considering in some cases. It is, however, notable that HMRC's late intervention was rejected for procedural reasons – not something taxpayers can rely on in future.

The decision in *Bhaur* should also be borne in mind. The taxpayers sought to unwind an EBT-based avoidance scheme but were refused, in no small part because of what the court considered to be the ‘social evil’ of tax avoidance. As a result, some 90% of the assets in the Bhaur trust were ultimately donated to the NSPCC.

EBT practitioners should ensure taxpayers are aware that, as history has shown, the courts may not always be able to step in to help.

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