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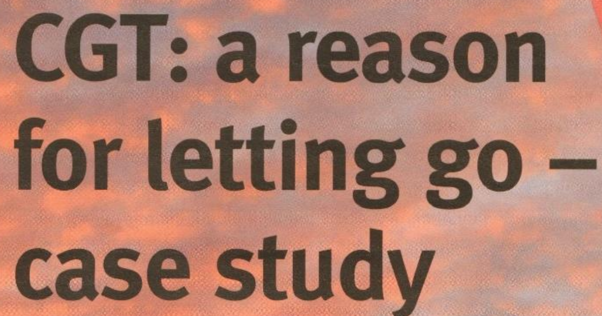

CGT: a reason for letting go – case study

Stephen Chater revisits the tax relief incentives introduced last year to encourage employee ownership of UK companies

The government's tax-led incentives designed to promote increased employee ownership are proving popular and taking hold.

The tax reliefs were contained in the Finance Act 2014. Since their introduction, a number of companies have moved to employee ownership using the new incentives. As a result of the reliefs, the sale of a controlling interest in a company to an employee ownership trust (EOT) became entirely free from capital gains tax (CGT), and future bonuses paid to their employees exempt from income tax.

Here we look at a company which has taken advantage of these new tax reliefs, and has now successfully completed employee ownership trust transactions. This will provide an insight into what was involved.

Case study

The company is based in the UK but has operations in several other parts of the world. It provides IT consultancy and systems design for a range of blue chip customers and has 100 employees, with growing profits. Before its sale to an EOT, 70 per cent of the company was owned by two founding shareholders, while a group of more senior employees held the remaining 30 per cent.

Why was employee ownership chosen?

The founding shareholders wanted to retire from the business. At the outset, they considered a sale to a third party but although there were interested potential purchasers, the founders eventually came to the conclusion that this was not the most attractive succession choice for the company.

On reflection, they felt the company could easily become a less rewarding and fulfilling place to work, concluding that this was not in the interests either of the long-term performance of the company or of its employees, who would be critical to its success.

Having dismissed the idea of a sale to a third party, the controlling shareholders turned their minds to exploring employee ownership. Following careful analysis and having taken some professional advice, they decided that this was the most attractive solution both for the company's future success and its employees.

The subsequent announcement of capital gains tax relief on selling to an employee ownership trust,

which became law under the Finance Act 2014, made this choice still more appealing to them.

What was involved?

Once an EOT had been established by the company, advance clearance was obtained from HMRC that any tax payable by UK taxpayers on the proceeds of selling their shares to the EOT would be CGT (as opposed to dividend income tax), following which full relief against CGT could be claimed.

The company's shareholders took professional advice on the business's current value, then entered into a contract with the EOT under which the EOT agreed to purchase all the shares in the company. The EOT is funded by the company out of its profits.

The EOT made an initial payment to the selling shareholders financed by the company's retained profits, but it was intended that the balance of the purchase price would be paid within the next five years out of future profits.

The EOT does not intend to distribute any of its shares in the company to employees. Employee ownership is therefore indirect (through the EOT), with rewards linked to future performance under a new bonus plan which extends throughout the company.

Indirect employee ownership was preferred by the company since this would avoid any need for regular transactions in shares by and between employees, and because enabling employees to benefit from capital growth was not regarded as one of their strategic priorities.

As part of the restructuring, the company will make use of the second tax relief introduced in 2014, under which it can pay bonuses to all employees of the company free from income tax, accompanied by a separate bonus plan for its more senior employees.

Who is in charge of the EOT?

The EOT controls the company by virtue of its majority shareholding, but this does not mean it manages the company. The directors of the company continue to be responsible for the day-to-day running of the business, and in the short term, the founding shareholders will continue to perform this role.

The EOT has trustees who are responsible for its operation. The trustees comprise one employee, one director and one independent individual from outside the company. The beneficiaries of the EOT are the company's employees as a whole, so the trustees have a duty to act in the best interests of the employees overall.

To a significant degree, this duty involves ensuring that the company's directors are managing the business effectively, and that it generates strong profits which can be shared with employees and invests in the future. It also means fostering a company culture which is positive and rewarding for its employees and which encourages them to contribute wherever possible.

> **“The EOT does not intend to distribute any of its shares in the company to employees”**

Conclusion

The early signs are that employee ownership in UK businesses is growing, particularly as an attractive ownership succession solution. The new tax reliefs are certainly encouraging more and more companies to look at it.

Companies do not generally seem to be encountering major obstacles and with careful planning and appropriate advice, they're finding they can implement an employee ownership structure that meets their situation and objectives.

A transition to employee ownership might not be appropriate in all cases, but the government has succeeded in establishing it as an option which will merit consideration in many situations. We expect there to be continued interest and activity in this area, as awareness of the opportunities which are available becomes more widespread. ■

Key questions for business owners facing succession issues

- Does your business have good prospects for a successful future?
- How reliant is your business on the skills and abilities of its employees?
- Do you think your business would fare better under third party or employee ownership?
- Can you arrange a successful management transition using existing members of your team and/or external recruitment - perhaps combined with your own gradual retirement from management?
- If so, could employee ownership help your company retain employees, or at least those who are key to the business?
- Is a sale to the highest bidder your only priority or will you have other considerations?
- If employees do not have access to sufficient funds to purchase the business, are there sufficient retained profits in the business to fund an EOT to purchase at least the first part of the purchase price?
- Are future profits likely to be sufficient to fund an EOT to pay the balance of the purchase price over a period of years?

Stephen Chater is share plans director at Postlethwaite Solicitors. His original article on CGT can be viewed on the PCA website (www.postlethwaiteco.com)