The renaissance

Are we about to see the rebirth of employee trusts? ROBERT POSTLETHWAITE considers two new proposed tax reliefs intended to encourage more employee-owned companies.

Given HMRC's sustained and all-out assault on employee trusts in recent years, it might come as a surprise that in early July the Treasury announced plans for two new tax reliefs associated with them. Having been all but battered into submission, employee trusts now look set to be given the kiss of life. What precisely is going on?

Fostering employee ownership

The government wishes to see significant growth in the number of companies that are employee-owned, believing that this will help to create a range of economic benefits. This policy strand is distinct from the employee shareholder status that became available on 1 September and which has already been dissected in previous *Taxation* articles. The motivation for this later proposal appears to be deregulation and this seems to be deeply flawed on more than one level.

The wider employee-ownership approach is completely different, in terms of both rationale and practicality. Since January 2012, the government has been separately considering how to bring about a growth in employee ownership, by which it means that a significant part of a company is owned by its employees on a widespread basis. This goes way beyond operating an option plan over a small percentage of equity for a small number of key people, or offering free shares only to employees who have agreed to give up certain key

employment rights. The government commissioned the Nuttall review into employee ownership which reported in July 2012 (see *Sharing success* at www.lexisurl.com/ty9io), then subsequently confirmed its agreement to many of the review's recommendations. The most recent development in government support for the growth in employee ownership is the proposal by the Treasury for new tax incentives. In its consultation paper *Supporting the Employee-Ownership Sector*, released on 4 July 2013 (www.lexisurl.com/bl7ty), the Treasury announced that it is to set aside £50 million per year to support the growth of employee ownership and to provide two new tax reliefs, in each of which it looks likely that an employee trust will be an essential feature.

KEY POINTS

- Two new tax reliefs may provide a new life for employee trusts.
- The government adopts the recommendations from the Nuttall review.
- Capital gains tax exemption for disposal of a "controlling interest" to an "indirect employee ownership structure".
- Income tax and NIC exemption on bonuses paid by indirectly employee-owned companies.
- Consultation on proposals until 26 September 2013.

Trusts and share ownership

Before reviewing the proposed reliefs, it is worth looking at some context relating to the use of employee trusts. For a while, employee trusts were used extensively in individual remuneration tax planning until the combined forces of the House of Lords judgment in *Dextra Accessories Ltd & Others v MacDonald* [2005] STC 1111, CTA 2009, Part 20 and ITEPA 2003, Part 7A brought down the curtain. However, they do have a rather longer history as a key component in the structure of employee-owned companies. Companies such as John Lewis are trust-owned, and more recently established businesses wanting to become employee-owned will often be advised to set up an employee trust. An employee trust can be a convenient vehicle for transferring a company's ownership from its founders to employees. The company funds the trust from profits (present and future), enabling it to acquire shares which it then either distributes to employees, retains on a long term basis, or combines these two approaches.

While employee trusts are a practical and convenient way to create employee ownership, they can hardly be placed in the tax planning premier league. Indeed, the current taxation regime does little to encourage shareholders planning succession to contemplate a transition to employee ownership.

Tax pros and cons

Company contributions to an employee trust will invariably be made from post-corporation tax profits, although to the extent that shares are then transferred to an approved share incentive plan (SIP – see ITEPA 2003, Part 7, Ch 3 and Sch 2) and distributed to employees as free or matching shares, a tax deduction does become available. There is also a deduction where a SIP acquires a 10% shareholding (CTA 2009, s 989 to s 993), and also a facility for a seller of the same minimum percentage holding to a SIP to roll over their capital gains into new chargeable assets (TCGA 1992, s 236A and Sch 7C), although neither relief has been extensively used.

Selling shareholders have the challenge of securing capital gains tax treatment on the gains made from sale, rather than these being treated as a distribution.

ITA 2007, s 686 permits capital gains tax treatment where there is a "fundamental change of ownership", but this requires at least 75% of the company's shares to be sold. Sales to an employee trust of less than 75% require a compelling case to be made to HMRC as to why obtaining an income tax advantage is not a main purpose. A company may only be able to fund an employee trust to acquire 51%, sometimes less than that. Clearances can be refused in these circumstances.

On a more positive note, where, after completing ownership succession through a transfer to an employee trust, a company wishes its employees to acquire personal ownership of shares, the enterprise management incentive (EMI) scheme and approved share plan (ITEPA 2003, Part 7 , Ch 6 to Ch 10) legislation does provide a helping hand.

Option gains under EMI, approved and SAYE options are subject to capital gains tax rather than income tax and National Insurance, with entrepreneurs' relief now available on disposals of shares acquired through EMI options. Relief against income tax and National Insurance is available on shares purchased through a SIP, and free shares can be awarded free of income tax and National Insurance. No capital gains tax is due on the disposal of shares acquired through a SIP. However, care is needed where an employee trust controlling the company has a corporate trustee, because this will prevent it establishing an approved or EMI plan.

The overall picture is that where shareholders have a choice between selling to an employee trust or a third-party external buyer, the better financial choice will often be to do the latter. This does not deter some from choosing the employee trust, but this is often because of their existing knowledge of employee ownership and belief that it is right for their company, which trumps any goal of maximising net sale proceeds.

The government wants companies that may not know about employee ownership to consider it as a succession solution. It appears that, after extended scrutiny and scepticism, the Treasury is sufficiently persuaded of the merits of employee ownership that it proposes not just one but two new tax reliefs, intended to encourage companies to do so.

Zero capital gains tax

It is proposed that chargeable gains incurred by individuals and personal representatives who dispose of a "controlling interest" to an "indirect employee ownership structure" will be exempt from capital gains tax.

What do these terms mean? It is suggested that a "controlling interest" would, in a company, be shares giving their holder more than half of the voting power. However, the Treasury appears willing to consider arguments for this to be set at a lower threshold. An "indirect employee ownership structure" appears to mean an employee trust which operates for the benefit of a majority of employees (differentiating it from one that is able to target benefit to a narrower range of employees).

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The consultation seeks views on a number of questions.

- *Should the relief be extended beyond individuals and personal representatives, for example to family trusts?* There seems no reason why a family trust should not be able to claim the relief, taking into account that if it cannot, it will not be able to claim entrepreneurs' relief.
- *Should the relief only be available to one individual, or to all selling shareholders?* Many companies that contemplate ownership succession through employee ownership will have several shareholders, and to limit the relief to only one of them would appear to be a recipe for destructive and insoluble arguments about who should be able to claim it.
- *Should the relief apply only to share disposals or also to ownership in unincorporated businesses?* It would seem logical to allow the relief to cover disposals of controlling interests in partnerships and limited liability partnerships.

One question that the Treasury has not asked is: what level of ownership transfer to an employee trust should bring sellers within capital gains tax rather than dividend income tax? The author's view is that this be set no higher than 51%, with scope for HMRC clearance for smaller disposals.

The Treasury favours limiting this tax relief to companies that choose indirect employee ownership, presumably because they think that once individual employees begin to own shares an onward sale of the company may become more likely.

We should expect to see a limit on the value of shares for which this exemption will be available, either per company or per shareholder.

One view of the rationale behind this new relief is that it will level the playing field where company owners are considering a choice between a trade sale and a sale to an employee trust. Selling to an employee trust, relying as it does on the company's ability to generate sufficient future profits to fund the trust to pay the total purchase price, will often mean shareholders agreeing to a discounted price, compared with what they might receive on selling to a trade buyer. Assuming entrepreneurs' relief is available, allowing a full capital gains tax exemption effectively means that selling shareholders can agree a 10% discount on a sale to an employee trust, receiving the same net proceeds as if they had sold to an external purchaser and paid capital gains tax.

Income tax and NIC exemption

The second proposed tax relief will be an exemption from income tax and National Insurance on bonuses paid by indirectly employee-owned companies.

Companies owned through an employee trust argue that they suffer a fiscal disadvantage compared with companies which have direct employee share ownership. While the latter can share profits with employees as dividends at the dividend tax rate, profit shares paid to employees who do not directly hold shares are subject to employment income tax and National Insurance liabilities.

The Treasury's second proposal seeks to address this disadvantage by allowing employees of companies that are indirectly employee-owned an exemption from income tax and National Insurance on annual bonuses. The exemption will apply to cash payments only, not to transfers of shares or other assets, and there will be an annual upper limit per employee (still to be defined). Many readers will remember profit-related pay, and there may be anti-avoidance provisions to ensure that this new exemption is only used by those companies for which it is intended.

Will this change anything?

In the Nuttall review, one barrier to the growth of employee ownership was identified as a lack of know how. Part of the government's thinking in introducing the new capital gains tax relief may be to raise the profile of employee ownership as a succession choice among professional advisers, so that it is placed on the agenda in discussions with company owners thinking about succession.

In a perfect world, more extensive tax reliefs would be available, in particular a new form of corporation tax relief for contributions to employee trusts, perhaps similar to those available to employee stock option plans (ESOPs) in the USA under the Internal Revenue Code. This is not currently in prospect and, in the author's view, we have to be realistic about the degree to which new tax incentives are going to be provided. We should therefore be seeking to help our clients make the best use of these new reliefs when they become available and where they are appropriate.

The proposals can be downloaded from the Treasury website (www.lexisurl.com/bl7ty) and are available for consultation until 26 September 2013. It is currently anticipated that legislation will be contained in the Finance Bill 2014.

Robert Postlethwaite is managing director of Postlethwaite, solicitors specialising in employee share plans and employee ownership. He can be contacted by phone on 020 7470 8805 or rmp@postlethwaiteco.com.