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Employee trust incentives

Robert Postlethwaite considers a new capital gains tax exemption for private company owners who sell to an employee ownership trust, and a connected income tax benefit for the company's employees, brought in by the UK *Finance Act 2014*

For a private company owner planning retirement and considering how to realise the value built up in their company, new tax reliefs brought in by the UK *Finance Act 2014* may offer an attractive alternative to a trade sale.

The *Finance Act 2014* introduces a new capital gains tax (CGT) relief for shareholders who sell to an employee ownership trust (EOT) that acquires control of the company. It also allows a company controlled by such a trust to pay its employees income-tax-free bonuses.

Given HMRC's hostility to many forms of employee trust over recent years, they are now set to be given a new lease of life. Why has the government created two new tax reliefs connected with employee trusts, and how do they work?

INCREASED EMPLOYEE OWNERSHIP

The government wants to encourage employee ownership of more companies, believing that this will help create a range of economic benefits, including increased productivity and improved performance. Research provides much evidence to support this view, and the government-commissioned 2012 *Nuttall Review of Employee Ownership* made a number of recommendations for achieving a significant growth in employee ownership.

Employee trusts have, for some years, been used extensively in individual remuneration tax planning, although recent anti-avoidance legislation has been very successful in closing the door on this. However, they have a far longer history as a key element in structuring employee-owned companies. Companies such as John Lewis are trust-owned, and more recently established businesses seeking to become employee-owned will often be advised to set up an employee trust. This is a convenient vehicle for transferring a company's ownership from its founders to employees, the company funding it from profits (present and future) to acquire shares which it then either distributes to employees, retains on a long-term basis, or a combination of the two.

The *Finance Act 2014* recognises the suitability of the employee trust as a way of transferring ownership from current owners to employees, and builds the new tax reliefs around this. The tax reliefs are as follows.

ZERO CGT ON SALES TO AN EMPLOYEES' TRUST

An addition to Part 7 of the *Taxation of Chargeable Gains Act 1992* (TCGA) provides that a disposal by an individual of ordinary shares in a company to an EOT is to be treated for the purposes of the TCGA as if neither a gain nor a loss accrues.

The main conditions for the tax relief are set out in new sections 236H to 236U TCGA. At the time of the disposal and throughout the tax year in which the disposal is made:

- the company must be a trading company (or holding company of a trading group); and
- the trust must meet the all-employee-benefit requirement (see below).

Additionally:

- the trust must not hold a controlling interest in the company before the transfer to it, but must do so at the end of the tax year in which the transfer to it takes place;
- where the transferor has an interest of more than 5 per cent in the company in the 12 months before they transfer their shares to the EOT, the ratio of employees who held 5 per cent or more of the company to employees generally must not have exceeded two-fifths in that period (the 'participator fraction').

A trust will satisfy the all-employee-benefit requirement if, whenever it provides benefits (such as cash or shares) to individual employees, it does so in favour of all eligible employees, and on the same terms (separately called the 'equality requirement'). The trust cannot, therefore, skew benefits to the advantage of particular employees, although it can allocate benefits of differing amounts by reference to factors such as salary, length of service or hours worked. 'Employees' can also include certain dependants of deceased employees.

There is no requirement for the trust to distribute to employees. It can simply retain its shareholding on a long-term basis, creating indirect employee ownership similar to that found at John Lewis.

The government has accepted that it could be difficult for existing employee trusts to satisfy the all-employee-benefit requirement without significant changes to their constitutional documents. An existing employee trust can, therefore, be deemed to meet the all-employee-benefit requirement, if, broadly:

- the way in which it operates is consistent with the all-employee-benefit requirement;
- the trust had at least a 10 per cent shareholding in the underlying company at 10 December 2013;
- the trust subsequently obtains control of the company.

Where an employee trust acquires shares from retiring owners, generally the funding for the trust will come from the company itself out of retained or future profits, which will often require those selling to receive their sale proceeds over a period of future years. The new CGT relief is intended to mitigate the effect of this, and also to encourage owners to sell where the transaction might only be affordable if the trust pays a price below the company's theoretical market value. It eliminates, too, the need for the trust to issue loan notes to defer liability to pay CGT, making it simpler to structure the transaction. A further goal of the legislation is to increase the prominence of employee ownership among professional advisors as a succession choice.

The legislation contains no guarantees that the seller's sale proceeds will be subject to CGT rather than income tax as disguised dividends. It is, therefore, advisable to seek prior clearance from HMRC under s701 *Income Tax Act 2007* that the taxation treatment will be under TCGA, allowing the exemption to apply. However, there is no procedure for advance clearance that the exemption itself will apply to the sale.

It will be no surprise that the exemption is subject to anti-avoidance provisions.

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If any of the following occurs during the tax year following that in which the disposal is made, the relief may not be claimed:

- the company ceases to meet the trading requirement;
- the trust ceases to meet the all-employee-benefit requirement;
- the trust ceases to control the company;
- the participator fraction exceeds two-fifths; or
- the trustees act in breach of the all-employee-benefit requirement.

Further, if any of the same events occur at any later date, the trust will be deemed to have immediately disposed of the shares that gave rise to the original CGT relief and reacquired them for their market value at that time.

INCOME TAX RELIEF ON BONUS PAYMENTS TO EMPLOYEES

Bonuses paid to employees of a company or group that is controlled by an EOT will be exempt from income tax, up to an annual limit of GBP3,600 per employee. National insurance will, however, still be payable. The key requirements for this new relief are very similar to those applying to the CGT relief:

- The employer company must be a trading company or a member of a trading group for the period of 12 months up to the date when the payment is made (the 'qualifying period').
- A controlling interest in the company, or, in a group of companies, the principal company of the group, must be held by an EOT throughout the qualifying period (although, for this purpose, the period begins when a controlling interest was acquired).
- Provisions very similar to the equality requirement for the CGT exemption also apply to the income tax exemption, and these must apply throughout the qualifying period (similarly, here the period begins when the equality requirement was first met).
- The company should not have more than a ratio of 2:5 for office holders and directors to employees.
- The payment must not consist of normal salary, must not be made by a service company and must be made under an arrangement that provides that:
    - all employees of the company, or, where there is a group, any group company, must be eligible to participate in any award (although employees with continuous service of less than 12 months can be excluded); and
    - all employees participating in the arrangement must do so on equal terms (although awards can be determined by reference to pay, length of service or hours worked).

This new relief became available on 1 October 2014.

INHERITANCE TAX RELIEF ON TRANSFERS TO AN EMPLOYEE OWNERSHIP TRUST

A third, less significant, change provides an additional inheritance tax exemption on gifts to an EOT, where the exemption already available under s28 *Inheritance Tax Act 1984* is not compatible with the requirements of the CGT exemption.

CONCLUSION

Professional advisors asked by private company owners to help them arrange ownership succession should be considering a sale to an EOT alongside any other possible solutions. This may be a good solution for the business commercially, and the tax reliefs for owners and employees alike may tip the balance in its favour.