Following the John Lewis example

Advisers to families and small business should be alert to new tax incentives that encourage growth in employee ownership, says **Stephen Chater**

Stephen Chater is share plans director at Postlethwaite Solicitors www.postlethwaiteco.com

Many lawyers who specialise in advising private clients might be aware of the fact that there are tax-advantaged arrangements for the acquisition of shares by employees, but they will often not worry too much about such arrangements on the basis that they are unlikely to impinge on their day-to-day practice.

However, private client specialists who advise family firms and small businesses should not ignore two new tax-led incentives introduced by the government last year to promote increased employee ownership.

Following the Finance Act 2014, the sale of a controlling interest in a company to an employee ownership trust (EOT) can be entirely free from capital gains tax (CGT), and future bonuses paid to their employees are exempt from income tax.

Here, we consider how one company has successfully become employee-owned using these new tax reliefs.

Case study

The two founding shareholders owned 70 per cent of the shares, with senior employees holding the remaining 30 per cent.

The founding shareholders wished to retire from the business, but they rejected the idea of a sale to a third party. They felt that, following such a sale, the company could easily become a less rewarding and fulfilling place in which to work, which would not be in the interests either of the longer-term performance of the company or of its employees, who would be critical to its success.

Having taken some professional advice, they decided that employee ownership was the most attractive solution for both the company and its employees. The subsequent announcement of 100 per cent CGT relief on selling to an employee ownership trust, which became law under the Finance Act 2014, made this choice still more appealing.

The company established an EOT, and advance clearance was obtained from HM Revenue & Customs to confirm that tax payable by UK taxpayers on the proceeds of selling their shares to the EOT would be CGT (rather than dividend income tax), following which 100 per cent CGT relief could be claimed.

Professional advice was taken on the company's value, and then the EOT agreed to purchase all the shares in the company.

The EOT is funded by the company out of its profits. It made an initial payment to the selling shareholders financed by the company's retained profits, the balance of the purchase price to 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. As with John Lewis, employee ownership is therefore indirect (through the EOT), with rewards linked to future performance under a 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 a strategic priority.

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, alongside an executive bonus plan.

The EOT controls the company by virtue of its majority shareholding, but the directors of the company continue to be responsible for running the company.

The beneficiaries of the EOT are the company's employees as a whole, so the trustees' duty is to act in the best interests of the employees overall. This duty involves ensuring that the company's directors are managing the company effectively, and that it generates strong profits which can be shared with employees and invests in the future.

The signs are that employee ownership in UK businesses is growing, particularly as an attractive ownership succession solution, supported by the new tax reliefs. Companies do not generally seem to be encountering major obstacles and, with appropriate advice, are finding that they can implement an employee ownership structure that meets their objectives.

A transition to employee ownership might not be appropriate in all cases, but advisers to small and family businesses should now be alert to the possibilities for a client for whom this might present an attractive opportunity. **SJ**

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