Securing the succession

Everyone dealing with private companies should be familiar with employee-ownership trusts, especially as a business succession solution, says GRAEME NUTTALL.

What would you say to a client asking about employee ownership as a succession solution? *Sharing Success: The Nuttall Review of Employee Ownership* (BIS) (the Nuttall Review) expressed concern that a professional adviser would not know how to react. When the Nuttall Review was published on 4 July 2012, relevant experience and expertise to advise on the subject were hard to find. There were few resources to support employee ownership, in contrast to the readily available information and resources on conventional business models, and there were misplaced concerns about the complexity of introducing and maintaining employee ownership structures. Two years on, the response from advisers should be very different. More advisers are now aware of employee ownership, there are more resources available to implement it and it is simpler to establish and maintain. A key difference is a set of tax exemptions relating to employee-ownership trusts. These exemptions have helped raise awareness of the employee ownership business model, made financing it easier and have simplified the introduction of the employee ownership trust model. The employee ownership trust tax changes will be confirmed when Finance Bill 2014, Sch 37 is enacted and this article assumes that it will be.

KEY POINTS

- The employee ownership business model is tried and tested.
- The employee ownership trust provides a straightforward way of implementing employee ownership.
- The pre-FA 2014 tax position was that relief would not be available to payments into the trust and a gain would arise on the owner's sale of shares.
- The new capital gains tax exemption on share disposals to an employee ownership trust.
- A new income tax exemption on qualifying bonus payments to employees.

The Nuttall Review (at page 18) posed a question relating to business succession:

> "The owner of a successful private trading company is planning for his retirement in a few years' time. No one in his family is able or willing to succeed him. He would prefer not to sell the business to a competitor and the business is too small to consider a stock market flotation. He would like to realise a capital gain in recognition of his success in building up the business. He has researched employee ownership and made some calculations. These show employee ownership is financially viable as a succession solution. He would therefore like to consider this as his succession solution. What happens next?"

This article suggests what the response would be now.

A tried and tested business model

An adviser may confidently say that the employee ownership business model is well tried and tested across different sizes of business and in different sectors. The employee ownership sector consists of more than the long-established flagship businesses such as Arup, Swann Morton and the John Lewis Partnership; there are many others, including Arrowfield

Veterinary Practice, Donald Insall Associates (conservation architects) and Wilkin & Sons (Tiptree jams). The Employee Ownership Association has an online map showing the geographic spread of its membership (www.lexisurl.com/dk7yt). These businesses believe that employee ownership helps deliver better business performance and a better workplace – a view backed by academics.

Direct or indirect?

An adviser will have to explain the distinction between direct and indirect employee ownership. The former means that employees own shares directly; the latter, that shares are held via an employee trust on behalf of the staff/stakeholders. A combination of both can be used.

Some owners will say instinctively that direct employee ownership is right for their business. But in the context of a succession solution the trust model has always been the starting point and the employee ownership trust tax exemptions reinforce this approach. This article therefore focuses on the trust model.

Although individuals could act as trustees, it is assumed that a UK tax resident company will act as the trustee. This helps avoid personal liability and the inevitable administration fees when a non-UK trust is used. If the trust is intended to hold shares indefinitely, why pay for non-resident tax status for capital gains purposes when the trustee may never realise a capital gain?

The indirect, or trust, model of employee ownership has always had advantages, including the following.

- It provides a straightforward way to co-ordinate the financing of employee ownership. In most circumstances, employees are unable to afford to purchase a significant proportion of their company's share capital personally. If a trust is used it may be financed by company contributions. Typically, a company will build up funds over several years until it is ready to make a cash contribution to the trustee to finance the purchase of shares from existing shareholders.
- It is easier to manage negotiations if they are with a single trustee (and its directors) rather than directly with a large group of employees.
- The trust model provides a stable and long-term structure for employee ownership. Shares held by a trust under the indirect model are retained permanently in that trust.
- Indirect employee ownership is easier to manage. The main decision is who should be on the board of directors of the trustee company? Typically, some directors are appointed by the board of directors of the founding company, while others may be selected from the employees as a whole, perhaps with one or two independent directors (eg a professional adviser). In comparison, direct employee ownership involves regular share valuations and financing an internal share market so that employees may buy and sell shares, especially when they join and leave.
- A trust provides an obvious structure for long-term employee engagement and participation in the business. The trustee can act as a collective voice for all employees and as "custodian" of the company's employee ownership ethos.

DEFINING EMPLOYEE OWNERSHIP

Practitioners are well used to advising on shares as financial incentives, especially for key executives. Employee ownership is a different concept. It means all employees hold a significant and meaningful stake in a company. The employees' stake should underpin the organisational structures that promote employee engagement in the company.

(*The Nuttall Review*)

- The tax position of shares held permanently in a trust is straightforward. The shares are held on discretionary trusts (and not earmarked for any particular employees) so that there are no employer or employee tax liabilities.

An employee trust buyout

The idea that could appeal to the client looking for a succession solution is that of an employee trust buyout. Over a number of years his or her company would make donations to the trustee of a trust and these are used to buy all of the owner's shares. In this way, the company becomes 100% employee-owned. The commercial benefits of employee ownership can be achieved without necessarily moving to 100% employee ownership, although supporters of this concept generally aim for ownership of more than 50% of a company's equity (by or on behalf of employees). The government has endorsed this approach: the employee ownership trust tax exemptions are dependent on the trust holding a controlling interest (as defined).

The basic tax proposition

Once the idea of an employee trust buy-out is accepted as a commercial succession solution, the basic tax proposition needs to be agreed. The basic tax proposition before the FA 2014 statutory reliefs apply is that:

- the shares will be retained permanently in the trust and the trading company will not be entitled to a tax deduction for the contributions it makes to the trust to buy shares because no taxable benefits will ever be received by employees (CTA 2009, s 1290); however
- the owner should realise a capital gain.

Owners are prepared to accept this proposition, albeit they would prefer the trust contributions to be tax deductible.

There is a way of achieving an upfront tax deduction for contributions to a tax-advantaged share incentive plan (SIP) but this involves introducing direct employee ownership (see more about this SIP alternative at the archived HMRC website content at: www.lexisurl.com/cv5gt).

If the owner wishes to go ahead with an employee trust buyout, a clearance application to HMRC CA Clearance SO528 (www.lexisurl.com/pk9nm) under ITA 2007, s 701 is advisable to confirm that the proposed payment or payments by the trustee company to the owner will not be considered,

ALL-EMPLOYEE BENEFIT REQUIREMENT

TCGA 1992, s 236J

(1) A settlement meets the all-employee benefit requirement if the trusts of the settlement:

   (a) do not permit any of the settled property to be applied, at any time, otherwise than for the benefit of all the eligible employees on the same terms;

   (b) do not permit the trustees at any time to apply any of the settled property:

      (i) by creating a trust; or

      (ii) by transferring property to the trustees of any settlement other than by an authorised transfer;

   (c) do not permit the trustees at any time to make loans to beneficiaries of the trusts; and

   (d) do not permit the trustees or any other person at any time to amend the trusts in a way such that the amended trusts would not comply with one or more of paragraphs (a) to (c).

(See, in particular, ss 236J(3) and (4) for the definition of "eligible employee", s 236J(7) for the definition of "authorised transfer", and s 236K regarding the requirement in s 236J(1)(a))

in effect, as disguised dividends. HMRC are likely to ask additional questions before replying substantively. Assuming that the arrangements do not have the obtaining of an income tax advantage as their main purpose or one of their main purposes, clearance should be forthcoming.

The above tax proposition now needs updating to take into account the employee ownership trust tax regime.

Employee ownership trusts

Until 5 April 2014, employee trust buyouts were typically carried out using an employee benefit trust that satisfied the requirements of IHTA 1984, s 86 (a section 86 trust).

The employee ownership trust tax exemptions now mean that the type of trust used is likely to be one that also satisfies the ***All-employee benefit requirement*** in TCGA 1992, s 236J.

The feedback from clients currently contemplating an employee trust buyout is that they are prepared to accept these additional restrictions. The employee ownership trust will, admittedly, have less flexibility to respond to changes than a section 86 trust but in many ways the requirements make the indirect employee ownership proposition much clearer and more straightforward to explain. An employee ownership trust is designed to retain shares permanently and is not intended as the vehicle through which financial benefits are provided to employees.

Once this is understood, the additional employee ownership trust restrictions become more acceptable. As I will explain, instead of receiving dividends, the trustee is likely to arrange for bonuses to be paid by the employing company. If it turns out that distributions are made from the employee ownership trust, every employee (with a continuous period of employment of at least 12 months) must benefit from that distribution on the same terms. This concept is similar to the same-terms concept in SIPs (ITEPA 2003, Sch 2 para 9).

The new CGT exemption

An owner expects to pay capital gains tax (CGT) at an effective rate of 10% when selling his company because entrepreneur's relief usually applies. In broad terms, if a controlling interest is sold to an employee ownership trust there is, from 6 April 2014, a complete capital gains tax exemption under TCGA 1992, s 236H. This tax saving is unlikely, on its own, to make an owner choose an employee trust buyout over a conventional exit route, but it certainly draws attention to the idea.

This new exemption also helps, for example, to dispel concerns over price. In the absence of a third party offer, an owner may doubt he or she is getting the right price: the extra tax saving can make it easier to agree on a price. The exemption is also making conversions to employee ownership happen sooner. A company may previously have started out with the aim of a trust buying, say, shares from minority shareholders and leaving to later the move to acquiring a controlling interest. In response to the employee ownership trust capital gains tax exemption, owners are agreeing to sell a controlling interest to a trust upfront and to finance this through instalment payments. The exemption makes "vendor financing" much easier to arrange. For example, there is no need to issue loan notes.

In contrast to the complexities that can arise with entrepreneurs' relief, claiming the exemption under s 236H is relatively straightforward. The relief requirements are, in outline (all references are to TCGA 1992):

- the relevant company is a trading company or the principal of a trading group (see s 236I);
- the trust meets the all-employee benefit requirement;
- the trust does not meet the controlling interest requirement (see s 236M) immediately before the beginning of the tax year in which the disposal occurs, but does meet it during the tax year and through to the end of the year;
- the limited participation requirement is met (see s 236N and below); and
- s 236H does not apply in relation to any related disposal by the claimant or a person connected with the claimant which occurs in an earlier tax year.

Assuming a claim for exemption is made, some disqualifying events (eg ceasing to meet the controlling interest requirement or trading requirement) will trigger a deemed disposal and reacquisition by the trustee of the employee ownership trust of the relevant shares (s 236P). Avoiding these events is, for the most part, within the trustee's control and so these risks are proving acceptable to trustees.

The limited participation requirement may be an obstacle in companies with relatively few employees compared with the number of shareholders who are employees or office-holders and who would benefit from the capital gains tax exemption. This requirement seeks to deny relief in some cases where the ratio of "participators" who benefit from the exemption to employees is greater than two in five.

Tax exemption for employees

There is a new tax exemption that benefits employees and therefore their business. In broad terms, some bonus payments made to employees of a company – or group – where an employee ownership trust has a controlling interest are exempt from income tax, but not from National Insurance contributions. This applies to qualifying bonus payments (as defined) up to £3,600 per tax year made from 1 October 2014 (ITEPA 2003, Ch 10A). In essence, all employees with at least 12 month's service must receive a payment on the same terms.

This exemption might prove more compelling in terms of deciding how a company's ownership should be structured. This income tax exemption is potentially ongoing rather than a one-off. This exemption removes an unfairness for otherwise 100% employee trust-owned companies that previously had to introduce a SIP if they wished to provide tax-free rewards to employees. Such companies may now keep to 100% employee trust ownership and still provide income tax-free rewards to employees.

A win-win outcome

From the 2014/15 tax year, an owner asking about employee ownership should receive a positive response from a professional adviser. This model of ownership and governance can deliver impressive commercial advantages and can also now be implemented in a straightforward and tax-efficient way using an employee ownership trust. Advisers are familiar with employee benefit trusts and understand how they work. All that is needed is to add to this existing know-how familiarity with the concept of employee ownership and with the detail of what an employee ownership trust is and its related tax exemptions.

The owner and senior managers of a company should have no difficulty in explaining the benefits of employee trust ownership to employees. Existing employee-owned companies welcome enquiries from those who want to discover more about the subject.

> *There is a new tax exemption that benefits employees.*

Hopefully, the response now to an owner asking his or her adviser about employee ownership as a succession solution, is "Yes, that's a neat idea. Let's take a more detailed look at how it might work in your case."

Graeme Nuttall OBE is a partner at Field Fisher Waterhouse LLP. He received his OBE in the Queen's Birthday Honours 2014 for services to employee share schemes, public service mutuals and employee ownership. He can be contacted on 020 7861 4652 or email: graeme.nuttall@fieldfisher.com.

Links to background materials on the Nuttall Review and more information on the employee ownership trust provisions can be found at: www.lexisurl.com/ws3er.