

Neat

Graeme Nuttall OBE sees employee ownership trusts as the perfect succession solution



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'EOTs will deliver benefits to selling shareholders, the employees that work in the company or group controlled by the EOT and should help the UK economy by creating successful long-lasting businesses.'

Too many owner managers have overlooked employee ownership as a business succession solution.

New tax exemptions should ensure that the indirect employee ownership business model achieves the recognition it deserves: one that provides a neat exit that is good for a business; good for employees and good for the UK economy.

Employee ownership (EO) is a great idea

EO is a great idea. EO delivers a significant and meaningful stake in a business to all employees. Employee-owned businesses are conventionally managed, successful businesses in which employees enjoy working and which deliver wider benefits. The lifespan of companies with EO is impressive. EO is an adaptable concept and whatever the business or the stage a business has reached EO can work well. It works particularly well as a succession solution.

Unfortunately, many professional advisers have not yet grasped the potential of EO. Advisers know how to implement employees' share schemes including establishing employee benefit trusts (EBTs), (typically offshore) as warehouses or market makers. But there has been an emphasis on delivering equity incentives to a select few executives and, even if an all employee plan is implemented, this has been more about delivering tax-efficient pay rather than improving employee engagement. Employee share ownership arrangements can work very well but tend to be add-ons to the standard corporate business model: not business models in their own right. It may be that an executive

share plan or an all employee share incentive plan (SIP) is all that is needed by a particular business. But for an increasing number of private companies in the UK, something else is needed and that something else is EO.

Politicians leading the way

Politicians are often accused of being reactive. In relation to EO they are leading the way. UK governments have previously supported EO in transforming public services. Minister for the Cabinet Office and Paymaster General Francis Maude has championed EO as a driver of higher productivity, effort and innovation for public services by encouraging public sector workers to form employee-owned businesses. Deputy Prime Minister Nick Clegg decided to take that message to the whole UK economy. He announced in January 2012 that he wanted EO in the bloodstream of the economy.

The essence of EO is that those employed in a business can genuinely say, as a group, 'we have a stake in this business' or as Nick Clegg put it: 'we are talking about a big chunk of the company belonging to a significant number of staff'. The employees' stake can vary but the flagship UK companies that embrace EO are all 100% employee owned companies: John Lewis Partnership PLC; Arup Group Ltd; the Scott Bader Commonwealth and Swann Morton and many other companies across many sectors.

Economic benefits

Sharing Success: The Nuttall Review of EO (BIS, 2012) summarised research on employee share ownership and EO. It is easy to see why politicians

are prepared to support EO. There are better business outcomes with EO:

- better business performance;
- increased economic resilience;
- greater employee commitment and engagement;
- improved innovation;

and what is particularly important is that these better business outcomes can be achieved alongside promoting happier staff through:

- enhancing employee wellbeing; and
- reducing absenteeism.

Types of EO

The *Nuttall Review* contains a definition of EO:

... employee ownership means a significant and meaningful stake in a business for all its employees... what is 'meaningful' goes beyond financial participation. The employee's stake must underpin organisational structures that promote employee engagement in the company...

The employees' stake could be held individually by employees or held, on their behalf, through a trust. In some cases a hybrid model is used in which, say, a controlling stake is held by a trust with an internal share market operating so that employees may also benefit from direct share ownership.

Instead of incentivising a select few through equity incentives, all employees are incentivised. Instead of offering incentives over only a small proportion of shares, as often happens through traditional employee share schemes, the employees together have a significant and possibly a controlling stake and that stake underpins employee engagement.

Employee engagement

Employee engagement has its usual meaning. *Engaging for success* (BIS, 2009) summarised the key drivers of employee engagement as:

- leadership which ensures a strong, transparent and explicit organisational culture;

- engaging managers who offer clarity, appreciation of employees' effort and contribution;
- employees feeling they are able to voice their ideas and be listened to; and
- a belief among employees that the organisation lives its values.

There are companies with good employee engagement where employees have no or insignificant shareholdings. What is different with EO is that there is an organisational integrity to all of the normal employee engagement drivers. Employees feel able to voice their ideas because it is their company: they know their ideas will be listened to.

Employees have financial participation, but EO also provides individual employee participation

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and an ownership culture encompassing what academics call a collective voice.

EO as a succession solution

The message is simple: EO provides a solution that is good for any business, in whatever sector it operates, of whatever size and at every stage of the business life cycle. EO often comes about as a business succession solution.

Consequently, if the existing owners of a business want a succession solution they should consider EO. Tiptree Jams is no longer a wholly family owned business: over time shareholders have sold a controlling stake to an EBT. Parfett's cash and carry business is now majority owned by an EBT. The family sold a controlling stake to the EBT as a succession solution. This year Arrowfield Veterinary Practice Ltd became a 100% EBT owned vets practice, after buying out the practice from its owner.

A neat exit

EO can have clear advantages over alternative exit strategies. Better than

a trade sale to, say, a life long competitor. Better than re-shaping the business so that it is suitable for a stock market listing. More attractive than the idea that the business could, over a period of time, be wound down and all staff made redundant. A management buy out might have potential but why sell to a few when the sale could be to all staff? Why not implement an employee buy-out (EBO)?

An EBO has a number of attractions:

- the terms of the EBO are, to a great extent, within the owners' control. Owners can plan in advance as to when and how the EBO occurs. This is a significant advantage over most other forms of exit;
- EBOs have a good record of succeeding. This is important if there is any deferred consideration.

And most founders of a business want to see their business survive and prosper; and

- an EBO avoids some of the difficulties that arise with other forms of exit. It avoids, for example, the commercial risk of disclosing confidential information to potential trade buyers.

Some owners prefer an EBO because:

- an EBO is a way of recognising the contribution employees have made to the success of the business;
- continuity of the business can be achieved for customers and suppliers;
- it can avoid the dismissal of employees or the closure of premises that often occurs following a trade sale; and
- the way the business is carried on, its ethos, is more likely to continue intact.

The trust model

The main area where there is likely to be a gap in know-how for advisers is in relation to the trust model of EO (also referred to as indirect EO). Many advisers are used to using EBTs for remuneration planning and the UK government has taken a number of measures to counteract what it considers unacceptable uses of EBTs. The focus of advisers has

- there is a tool kit for employee trust ownership on the gov.co.uk website;
- HMRC has published accompanying guidance on tax issues to consider, and
- Chancellor George Osborne’s Autumn Statement 2013 speech confirmed that:

Most EBOs are implemented by using a trust because this is simpler than co-ordinating a sale to employees individually.

been so skewed over recent years they have forgotten that an EBT has a sound commercial use, which is acceptable to HMRC, as a trusted long term owner of shares in a company for the benefit of all its employees.

Most EBOs are implemented by using a trust because this is simpler than co-ordinating a sale to employees individually. The new tax exemptions described below will reinforce this as the method of choice for EBOs.

Government action to support indirect EO

A range of government measures has promoted EO. In relation to indirect EO, in particular:

... the government will introduce a package of tax reliefs to support the employee ownership sector. and, in particular, new tax exemptions to promote the employee trust ownership of companies.

New tax exemptions

The government has introduced tax reliefs to encourage, promote and support indirect EO.

- from 6 April 2014 there is an exemption from capital gains tax (CGT) on gains on certain disposals of shares in a trading company (or in a holding company

of a trading group) that provide an employee-ownership trust (EOT) (as defined) with a controlling interest in that company (the ‘CGT exemption’); and

- from 1 October 2014 there will be an exemption from income tax (but not national insurance contributions (NICs)) of £3,600 per employee per tax year for certain bonus payments made to employees of a company (or group) where an EOT has a controlling interest (the ‘income tax exemption’).

CGT exemption

The CGT exemption should attract attention to EBOs as a succession solution. Instead of a sale of shares being taxed typically, for owner managers, at an effective rate of 10% (after entrepreneur’s relief (ER)) there is an unlimited exemption from CGT.

In contrast to ER there are few qualifying requirements on the part of the vendor. The details of the CGT exemption are contained in Part 1 of Schedule 37 of the Finance Act 2014, which received Royal Assent on 17 July 2014. A brief overview of the CGT exemption is as follows, it:

- cannot be claimed by companies;
- applies only to ordinary share capital;
- has to be claimed (the requirements are straightforward);
- in effect transfers the potential CGT liability to the trustee;
- only applies when the relevant shares are in a company (C) which is a trading company (or principal of a trading group);
- requires an employee trust that meets an ‘all-employee benefit requirement’ (ie an EOT);
- requires the EOT to meet a ‘controlling-interest requirement’ (see Table 1 left) for the first time;
- only applies to disposals in the tax year in which the controlling-interest requirement is acquired for the first (and only) time;

Table I: Section 236M(1)	
(1) A settlement meets the controlling interest requirement if:	
(a) the trustees —	
(i) hold more than 50% of the ordinary share capital of C, and	
(ii) have powers of voting on all questions affecting C as a whole which, if exercised, would yield a majority of the votes capable of being exercised on them,	
(b) the trustees are entitled to more than 50% of the profits available for distribution to the equity holders of C,	
(c) the trustees would be entitled, on a winding up of C, to more than 50% of the assets of C available for distribution to equity holders, and	
(d) there are no provisions in any agreement or instrument affecting C’s constitution or management or its shares or securities whereby the condition in paragraph (a), (b) or (c) can cease to be satisfied without the consent of the trustees.	

- needs a ‘limited participation requirement’ to be met to ensure that there is a sufficient change in ownership; and
- involves potential disqualifying events that could trigger a CGT liability on the trustee of the EOT in certain circumstances.
- does not apply to regular salary payments (and salary waiver arrangements);
- requires all employees in relevant employment to be eligible to participate (with a possible exception for recent joiners);
- the ability to retain settled property indefinitely without distributing it;
- the scope for the trustee to consult beneficiaries before the trustee exercises the votes on shares it holds or makes other decisions; and

Income tax exemption

EOTs also enable employees to benefit from an income tax exemption. The details of the income tax exemption are currently set out in Part 2 of Schedule 37. A brief overview of the income tax exemption is as follows, it:

- only applies where C is a trading company (or principal of a trading group) for (normally) 12 months prior to making qualifying bonus payments;
- requires an employee trust that meets an all-employee benefit requirement (ie an EOT) (see Table 2 below) for (normally) 12 months prior to making qualifying bonus payments;
- requires the EOT to meet the controlling-interest requirement for (normally) 12 months prior to making qualifying bonus payments;
- limits the amount each employee may receive income tax free in a tax year to £3,600 (with NICs liabilities remaining in place);

- requires everyone who does participate to do so on same terms (as defined); and
- has an exception for payments by service companies (as defined) eg that provide staff services outside C’s group.

The EOT

It is the EOT and the all-employee benefit requirement that is at the centre of obtaining these new tax exemptions. An EBT will typically satisfy the requirements of s86 Inheritance Tax Act 1984 (s86) (ie it will be a ‘section 86 trust’). An EOT is more restrictively defined. Nevertheless there are similarities between a s86 trust and an EOT that provide a familiar starting point:

In contrast to s86 trusts where a trustee may make a distribution on bespoke terms to a selected beneficiary, an EOT operates similarly to a SIP.

- the ability to include charity as a beneficiary.

But much of the flexibility usually built into an EBT has to be abandoned when drafting an EOT. The signs are that, in the context of indirect EO, these extra restrictions work well. Once shares have been sold into the EOT, the idea is that they stay there. The all-employee benefit requirement has to be understood in this context.

The all-employee benefit requirement

The following is a summary of some of the key differences between a s86 trust and an EOT as a result of the all-employee benefit requirement and why the EO sector considers them acceptable (references are to new sections in the Taxation of Chargeable Gains Act 1992 as introduced by the Finance Act 2014.):

- Anyone employed by C or C’s group must be an ‘eligible employee’ (although this does not include an excluded participator (as defined) (S236J(1)(a) and (3)).
This is a significant difference from the ‘all or most’ requirement under s86. In practice, this change fits in with the indirect EO model because:
 - the trustee will take all employees into account when making decisions;
 - if there is distributable income, the default position is usually that all employees should benefit, and

Table 2: Section 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 — <ul style="list-style-type: none"> (i) by creating a trust, or (ii) by transferring property to the trustees of any settlement other than by an authorised transfer [which is effectively a transfer to a trust which itself will be an EOT immediately after the 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).

- if the controlling interest is sold then the default position is again usually that all employees should benefit.
- Settled property must be applied 'on the same terms' (s236J(1)(a) and 236K).

This requirement is known as the 'equality requirement'. In contrast to s86 trusts where a trustee may make a distribution on bespoke terms to a selected beneficiary, an EOT operates similarly to a SIP. SIPs are well known as a method of achieving direct EO and so this requirement is accepted as appropriate for indirect EO structures. The equality requirement permits differing amounts to be paid to eligible employees but not so that some employees receive nothing at all. An individual's benefit from the EOT may be computed by reference to their remuneration, length of service, or hours worked, but entitlement on account of each factor must be computed separately and the total payment must be the sum of such relevant components.

A key point to appreciate is that the EOT may never actually make any payments to employees. It is the relevant employing company that will do this.

- The trustee must not be permitted, at any time, to make loans to beneficiaries of the EOT (s236J(1)(c)).

This is another material difference from a s86 trust. Interest free and other loans to (selected) employees who are beneficiaries would not infringe the provisions of s86. But again in an indirect EO structure, in practice, if any employee requires a loan this is typically made by the employing company (eg a season ticket or hardship loan) and does not have to be made by the trustee.

- An excluded participator cannot benefit at all from the application of settled property (s236J(1)(a) and (3)-(6)).

This is a significant change. If C is a close company then certain beneficiaries are usually excluded

under a s86 trust although typically the excluded participators are allowed to benefit from payments subject to income tax. Again, this extra restriction appears acceptable. It ties in with the practice that some excluded participators voluntarily agree to be excluded completely as beneficiaries from s86 trusts in order to demonstrate to employees and HMRC that there is a genuine change in ownership.

- Persons of a class defined by reference to marriage to or civil

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partnership with, or relationship to, or dependence on employees (or former employees) cannot be among the main beneficiaries of settled property in the EOT (s236J(1)(a)).

This is a significant change. Spouses, children, etc of employees and former employees may benefit under s86 trusts, and may be included either in the same main class of beneficiaries as employees or they may benefit from over-riding powers of the trustee. This is another change which appears acceptable as part of an indirect EO structure because, in practice, current employees are the sole main beneficiaries in indirect EO structures and a wider class of beneficiaries is not needed.

Neat, neat, neat

This article provides an introduction to EO, EBOs and the new tax exemptions that encourage the use of EOTs and indirect EO.

EOTs will deliver benefits to selling shareholders, the employees that work in the company or group controlled by the EOT and should help the UK economy by creating successful long-lasting businesses. Just as EOTs need to be placed in context, as trusts designed to own shares indefinitely, so it is important

to understand the role of the new tax exemptions.

The CGT exemption will raise awareness of EBOs as a succession solution. It is hoped that the relatively small tax differential between paying CGT at 10% on conventional exits and paying no CGT on a sale to an EOT will mean that tax does not become the main lever to promote EO. Instead the business case for EO should remain the main lever: better business outcomes, happier staff and a stronger more resilient economy.

Also the income tax exemption is about achieving fairness between

indirect and direct EO. As a result of the income tax exemption, EOT controlled companies will have an alternative to establishing a SIP, and using shares to make income tax free awards to staff: they may now pay income tax free bonuses to staff without detracting from their indirect EO structure.

Given the recent political support for EO this article concludes with an extract from the Robert Oakeshott Memorial Lecture given by Nick Clegg on 27 March 2013:

Too many businesses fail at the point of succession or soon after. Business owners can be faced with the unsettling task of handing their business on to new owners without knowing what those owners will do with the business they have cherished. Many end up selling to the investor who has the largest cheque book, but little regard for the traditions, employees and customers of the firm. Others hand the business on to their children even if that isn't what they or their children really want. What we want to encourage is for more owners to sell the business on to those people who know the business inside out, who will go the extra mile, the wider family who have worked to build it up and contribute to its success – in other words, the employees. ■