Tried and tested

Graeme Nuttall explains how employee-ownership trusts can produce better business outcomes

KEY POINTS

- **What is the issue?** Employee-ownership trusts are primarily a neat succession solution but can work in start-ups and at other stages in the business life cycle.
- **What does it mean to me?** Employee ownership particularly comes to the fore in business successions. This is why the government has introduced the new EOT CGT exemption.
- **What can I take away?** Employee ownership can produce better business outcomes as well as a great place to work.

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Profile Graeme Nuttall OBE, Solicitor and Chartered Tax Adviser is a partner in Fieldfisher's Tax and structuring practice. He received an OBE in the Queen's 2014 Birthday Honours for services to employee share schemes, public service mutuals and employee ownership. As the UK Government's independent adviser on employee ownership, he produced *Sharing Success: The Nuttall Review of Employee Ownershipthe UK*.

Employee-ownership trusts (EOTs) provide a refreshingly different ownership model for private companies. Anyone who focuses on the tax savings achievable through the new EOT tax exemptions is missing the big picture: employee ownership can produce better business outcomes as well as a great place to work.

EOTs are primarily a neat succession solution but can work in start-ups and at other stages in the business life cycle. Advisers need to rethink their answers to some standard questions from clients, such as what ways are there to sell my company?

Employee trusts are a proven succession solution

The usual succession solutions for owners of a company include a Stock Exchange listing, a trade sale or a sale to private equity, including a management buyout. Many businesses have made a different solution work well: a sale to all staff organised through an employee trust.

Wilkin & Sons (Tiptree jams) moved to employee trust ownership in the 1980s as did Donald Insall & Associates (conservation architects). There are other longer-established companies owned by employee trusts such as Arup, Swann Morton and the John Lewis Partnership. The Employee Ownership Association has more examples on its website (www.employeeownership.co.uk/home/).

The employee trust model is clearly tried and tested. Research also supports employee ownership as providing a 'win-win' business model; one that is good for the business itself and for its employees (see Chapter 2 in the *Nuttall Review of Employee Ownership* (BIS 2012) ('Nuttall Review')). Notwithstanding these success stories and academic support, until recently there has remained a stubborn lack of awareness of this ownership model across the business community.

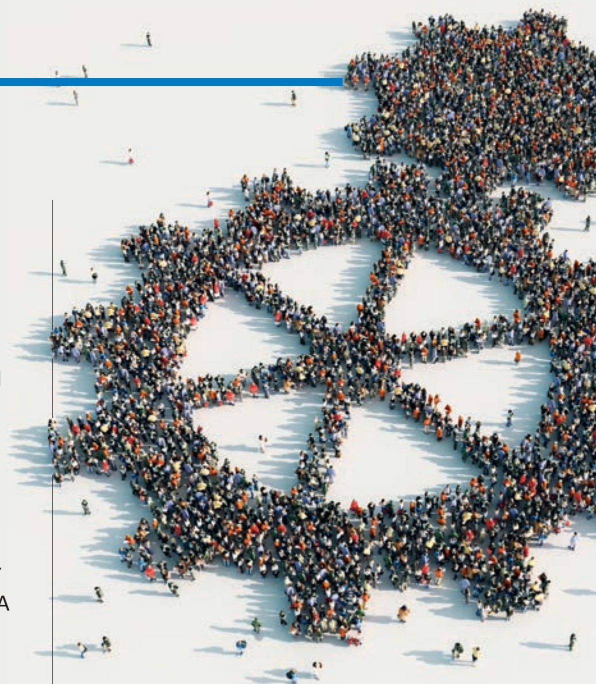
Nuttall Review

In 2012 the Deputy Prime Minister, Nick Clegg, announced the government's aim of putting employee ownership in the bloodstream of the UK economy. The government commissioned the Nuttall Review and subsequently endorsed its definition of employee ownership (see ***Table 1***) and measures to help establish employee ownership, in all its forms, in

TABLE 1 – NUTTALL REVIEW DEFINITION OF EMPLOYEE OWNERSHIP

'**Employee ownership** – means a significant and meaningful stake in a business for all its employees. If this is achieved a company has employee ownership: it has employee owners.

What is 'meaningful' goes beyond financial participation. The employees' stake must underpin organisational structures that ensure employee engagement. In this way employee ownership can be seen as a business model in its own right.'



the mainstream of the UK economy. In particular, following the findings of Nuttall, the government introduced new tax exemptions to support employee trusts. The aim of these measures is, primarily, to raise awareness of the trust model of employee ownership. These exemptions also help the financing of employee trust owned companies and to simplify this business model. The idea is that the tax exemptions will encourage owners and advisers to break with convention and adopt EOTs as a private company ownership model. For more on the Nuttall Review see www.tinyurl.com/nuttallreviewguide.

EOTs

The current benchmark for drafting an employee trust is IHTA 1984 s 86, which most satisfy. The flexibility of s 86 has encouraged employee trusts to try to minimise income tax and NICs on the remuneration of employees and directors as well as for employee ownership. A trust deed for an employee trust in an HMRC spotlighted avoidance scheme looks very much like a trust deed underpinning a genuine employee ownership arrangement. The government obviously wants the new tax exemptions only to support employee ownership and so they require a more tightly defined trust than a s 86 trust. The definition of an EOT combines a distillation of the usual key features of trusts used in genuine employee ownership structures but excluding certain trustee powers typically found in a s 86 trust.

Controlling interest requirement

A common feature of most long-established employee trust owned companies is that more than 50% of the business is owned by an employee trust (and often all the company's shares are held in trust). The government has adopted this approach and so an EOT must have a controlling interest (see ***Table 2***) in a trading company (or parent company of a trading group).

Participation and equality requirements

The main defining characteristics of an EOT are that it meets the participation and equality requirements. This is the place to start when testing whether an EOT provides the right ownership model for a company. These notable features are familiar to employee share plan practitioners, namely that all eligible employees should benefit (called the 'participation requirement') and that they should do so on the same terms if there is ever a distribution from the EOT (called the 'equality requirement') (TCGA 1992 ss 236J(1)(a)–236K and also ITEPA 2003 s 312C). Typically, the trustee of a s 86 trust can select which employees may benefit and to what extent. Under an EOT all employees must benefit from any distribution. These requirements have some flexibility built into them. Employees with less than 12 months' continuous employment may be excluded and distributions can be varied according to their remuneration, length of service or hours worked. However, the main reason why these requirements are acceptable is it is unlikely that any distribution will ever be made from the EOT. This follows on from the way the new income tax exemption for an EOT owned company operates (see below).

A key point to appreciate is that once an EOT has acquired a controlling interest, the aim is to keep that shareholding in the EOT permanently. An EOT is intended as a permanent vehicle for owning shares.

All-employee benefit requirement

As well as the participation and equality requirements, there are other conditions to meet, which are together defined as the all-employee benefit requirement. In particular, an EOT cannot create sub-trusts or make loans to beneficiaries. These conditions are informed by HMRC's experience of trusts used for remuneration planning. Further details of the all-employee benefit requirement are set out in ***Table 3***.

TABLE 2 – CONTROLLING INTEREST REQUIREMENT (TCGA 1992 S 236M(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.'

(See also TCGA 1992 s 236T)

Indirect not direct employee ownership

One reason why the employee ownership business model has not become mainstream is the fixation of advisers and past governments on direct employee ownership.

Since the 1970s tax-advantaged employee share plans have been part of the corporate landscape, especially in listed companies. In essence, such schemes have been add-ons to the conventional corporate business model and used either as a means to incentivise key executives or to provide tax-efficient financial participation for staff. Such arrangements work well but anyone focusing only on direct employee ownership misses a valuable part of the spectrum of employee equity incentives.

EOTs highlight a different way to use shares as an incentive – that of indirect ownership through an employee trust. The indirect model involves a trustee holding shares collectively on behalf of employees. This approach avoids the administrative and tax complications of direct share ownership. In private companies direct employee ownership invariably involves establishing an internal share market so that employees may buy and sell shares, and ongoing requirements to establish market value and report share acquisitions and disposals. Indirect employee ownership, as well as being simpler to operate, has academic support. Some research suggests that creating a 'collective voice' is key to getting the most out of employee ownership.

Not everyone in the employee ownership sector agrees. There are some strong advocates of direct employee ownership. Gripple Limited, for example, is an employee-owned company in which employees own shares directly. Even in this case, though, there is a vehicle to provide a collective voice for employees (known as GLIDE).

Some employee owned companies have a mix of direct and indirect employee ownership. Such hybrid models of employee ownership are also compatible with EOTs. The new legislation provides expressly

that an EOT-controlled company may also operate a share incentive plan, SAYE option scheme, company share option plan or enterprise management incentives arrangement (FA 2014 Sch 37 para 19).

There are special share identification rules if EOT trustees want to supply shares for a share plan as well as retain a controlling interest (TCGA 1992 s 236S).

New capital gains tax exemption

Individuals (and any persons other than companies) can get an unlimited capital gains tax (CGT) exemption on disposals of shares in a trading company or in the parent company of a trading group to an EOT.

Anyone advising on ways to sell a company must now consider a sale to an EOT. This exit route is particularly of interest to shareholders who do not benefit from entrepreneurs' relief (ER) or where their gain exceeds its maximum lifetime limit. Achieving a complete exemption from CGT should also be enough to ensure a sale to an EOT is considered even by those who benefit from ER.

In summary, TCGA 1992 s 236H provides that this CGT exemption:

- cannot be claimed by companies;
- applies only to ordinary share capital;
- has to be claimed (the requirements of making a claim are straightforward (see TCGA 1992 s 236H(7));
- only applies when the relevant shares are in a company that is a trading company (or principal of a trading group (TCGA 1992 s 236I));
- requires an employee trust that meets an 'all-employee benefit requirement' (see ***Table 3***);
- requires that trust to meet a 'controlling-interest requirement' (see ***Table 2***) 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; and
- needs a 'limited participation requirement' to be met to show there is a sufficient change in ownership (see TCGA 1992 s 236N).

The limited participation requirement is a possible problem in companies with relatively few employees in comparison with the number of shareholders who are employees or office-holders and who would benefit from the CGT exemption. This requirement seeks to deny CGT relief where, broadly, the ratio of participators who benefit from the EOT exemption to employees is greater than two-fifths.

There are potential disqualifying events that could trigger a CGT liability on the trustee of the EOT in certain circumstances (TCGA 1992 s 236O–R).

TABLE 3 – ALL-EMPLOYEE BENEFIT REQUIREMENT (TCGA 1992 S 236J(1)(A))

'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 TCGA 1992 ss 236J–U for meaning of authorised transfer etc)

New income tax exemption

The EOT business model also offers a tax exemption that benefits employees (and therefore the business in which they work). The details of this income tax exemption are set out in ITEPA 2003 Ch 10A Pt 4 which introduces an exemption from income tax for up to £3,600 per employment on certain qualifying bonus payments in any tax year (with NICs liabilities remaining in place).

Again the qualifying conditions are relatively straightforward and implementation will be much simpler than operating, for those who recall them, a tax-relieved, profit-related pay scheme. As mentioned above the qualifying bonus payments are not paid by the trustee of the EOT; they must be paid by a company. As with the CGT exemption, there must be an employee trust that meets an all-employee benefit requirement and the trust must meet the controlling-interest requirement for the period required under ITEPA 2003 Ch 10A which is (normally) 12 months before making qualifying bonus payments (ITEPA 2003 s 312E).

In summary, as well as the employer company (E) meeting the above indirect employee-ownership requirements throughout the qualifying period, other conditions must be met. Broadly, these are:

(a) each bonus must not consist of regular salary or wages;

(b) each bonus must be awarded under a scheme which meets the participation requirement and the equality requirement (ITEPA 1992 s 312C);

(c) E meets the trading requirement (ITEPA 1992 s 312D) throughout the qualifying period;

(d) E meets the office-holder requirement (ITEPA 1992 s 312F and below) at the time the payment is made and on at least the requisite number of days in the qualifying period (whether or not those days are consecutive);

(e) E is not a service company. For example, one that provides staff services outside a group (ITEPA 1992 s 312G);

(f) the payment is not excluded. For example, the employee does not give up the right to receive an amount of general earnings or specific employment income in return for the provision of the payment (ITEPA 1992 s 312H); and

(g) where it is a payment to a former employee, it is made in the period of 12 months beginning with the day the employment ceased.

The above office-holder requirement is a less restrictive version of the limited participation requirement. This seeks to deny income tax relief where the ratio of directors or other office-holders to employees (and office-holders) is greater than two-fifths.

Consider EOTs

This article provides an introduction to these new tax exemptions. There are other provisions (and indeed other related tax reliefs) not covered in this summary. For example, some s 86 trusts may be deemed to meet the all-employee benefit requirement. The aim is to encourage the consideration of EOTs when designing employee equity incentives and also more generally throughout the life cycle of a company. The income tax and CGT exemptions operate independently of one another. This means an EOT could be used in a start-up to access the income tax exemption. An EOT may provide a way to structure a business rescue. But, in practice, employee ownership particularly comes to the fore in business successions. This is why the government has introduced the new EOT CGT exemption. The new EOT tax exemptions and the recent publicity about employee ownership mean more companies are opting for employee ownership as a succession solution.