Employee ownership trusts: preparing for transition

Large Corporate | Employment Tax

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As more companies elect to transition to employee ownership, how can employee ownership trusts best prepare themselves for potential changes in the pipeline.

Key Points

What is the issue?

Employee ownership is a growth sector in the UK. The Employee Ownership Association identifies over 1,400 employee-owned businesses.

What does it mean to me?

Once a company has satisfied the requirements of the specific EOT legislation, there are other tax provisions for companies, selling shareholders and their advisers.

What can I take away?

The recent consultation states that the government is committed to supporting employee-owned companies across the wider economy and encouraging companies to transition to employee ownership but some changes might be on the way.

Employee ownership is a growth sector in the UK. The Employee Ownership Association identifies over 1,400 employee-owned businesses. Many of these are likely to have adopted the employee ownership trust (EOT) model created in 2014. The relevant legislation is now found in the Taxation of Chargeable Gains Act (TCGA) 1992 ss 236H to 236U and Income Tax (Earnings and Pensions) Act 2003 ss 312A to 312I.

This article considers two aspects of the taxation of this form of employee ownership. First, nearly 10 years on, is the current EOT legislation sustainable or does it need some changes? HMRC has been consulting on possible changes in 'Taxation of employee ownership trusts and employee benefit trusts' (see tinyurl.com/2sk6jbxn).

Secondly, you might be forgiven for thinking that once a company has satisfied the requirements of the specific EOT legislation, the tax issues are sorted. Unfortunately, there are other tax provisions to be navigated for companies, selling shareholders and their advisers.

The legislation and the future

The potential tax incentives for EOTs are:

- a capital gains tax exemption for individual shareholders who make a qualifying sale to an EOT;
- an income tax (but not NICs) exemption on bonuses of up to £3,600 per annum per employee;

- corporation tax relief on those bonuses; and
- an inheritance tax exemption on eligible gifts or sales at undervalue to EOTs.

The company that becomes employee owned receives no special reliefs but must comply with five key conditions for the shareholder and employee reliefs to apply.

Five key conditions for EOTs

1. Trading requirement

The shares placed in the EOT need to be in either a sole trading company or the principal company in a trading group. Additionally, the group's activities must not include to a substantial extent activities other than trading activities.

2. Controlling interest requirement

The trustees of the EOT must:

- own more than 50% of the shares in the company;
- have a majority of the votes;
- be entitled to more than 50% of the profits available for distribution (trustees can waive dividends if the trust deed allows);
- be entitled to more than 50% of assets available for distribution to shareholders on a winding up.

There must be no provisions in an agreement or instrument affecting the company's constitution which allow these conditions to cease to be satisfied in the future without the consent of the trustees.

3. All-employee benefit principle

With limited exceptions, all the company's employees must be potential beneficiaries of the EOT; and if benefits are paid out, it must be on the 'same terms' (see below). Employees with less than one year's service can be excluded.

The major exception from the all-employee principle is for employees and directors who, with ‘connected’ persons (including close family members), have or have had an interest in 5% or more of the shares, or any class of shares, during the previous ten years. This typically excludes former owners but could also exclude an employee who has held an option over 5% or more shares. This can prevent key managers from receiving a benefit from an EOT.

4. Equality requirement

The equality requirement is that distributions from the trust fund, or payments under a bonus scheme, must be for the benefit of all eligible employees of a company or group on the ‘same terms’ to qualify for the relief. ‘Same terms’ does not necessarily mean that all employees get equal amounts. It is possible to determine the size of awards by reference to remuneration, length of service and hours worked as long as the same method applies to all.

5. Limited participation requirement

This condition is that if a shareholder claiming relief had or was entitled to acquire 5% or more of the shares, or any class of shares, in the company (or its assets on a winding-up) – i.e. they were a 5% participator – at any time in the 12 months ending immediately after the disposal of shares to the EOT, the participator fraction must not be more than 2/5.

The participator fraction is:

- the number of people who are both 5% participators in the company **and** employees or officeholders of a company in the group **plus** the number of people who are employees or officeholders of a company in the group who are connected with another employee or officeholder who is a 5% participator;
- divided by the total number of employees in the group.

This can be a hard stop for small companies with few employees, many of whom are family members, or where employees have previously held shares obtained under an EMI or other share option plan.

These conditions are fiddly yet in most cases can be navigated. Even so, there are changes and simplifications that could be beneficial, and some have been put

forward by HMRC in its consultation that closed on 25 September 2023.

Who will be entrusted to be the trustee?

HMRC’s consultation focused in particular on who should be a trustee of an EOT. This could be an employee; however, often employees are not brought into the circle of confidence at the time of the sale of the shares and the vendor might be uncomfortable sharing the financial terms of the transaction with employees.

As a result, even where greater employee participation is proposed in the long run, in the short term typically this will be a corporate trustee with directors of the trustee company being thought of as the trustees.

HMRC has some concerns regarding the nature and identity of trustees.

The first is that the previous owners (the vendors), if they are sole trustees, will continue to effectively control and run the business by remaining the trustees or the trustee directors. HMRC is not asserting that this would be contrary to the controlling interest requirement in TCGA 1992 s 236M. Instead, it is suggested that it does not align with the policy objectives of transferring control of the company. Presumably, this is a situation that HMRC has seen arise in practice.

Those who have created and grown a business over many years may be justifiably anxious about handing it over to unknown custodians, particularly if a large part of the consideration is deferred. Even so, losing control is not the same as losing influence. The previous owners can be protected by a seat on the board, a consultancy role, suitable financial protections in the share purchase agreement or even by setting out guiding principles. These can be substantial arguments for convincing the vendors that they do not need to be the sole trustees.

HMRC’s consultation raised the question of whether there should be a fixed categories of persons who can act as trustees, such as employees or independent trustees. The author’s personal view is that the board of trustees should include an independent trustee, as well as employees or senior management to outvote a previous owner. However, to impose such a rule regarding the make-up of a board of trustees may be challenging, would require compliance with that rule to be

monitored and is likely to increase the running costs of an EOT.

Imposing a statutory obligation would, however, raise the concern that an accidental breach – such as an employee resigning or dying, combined with difficulties in finding a replacement (not all employees embrace such responsibilities) – could cause a disqualifying event, a deemed disposal and a significant capital gains tax liability for the trustees. Triggering a capital gains tax liability in this way also creates funding issues, as the EOT trust fund usually only holds the shares. The only solution to this could ultimately be to sell or liquidate the trading company to fund the tax liability.

HMRC's second concern about trustees is whether they should have to be UK resident only. Currently, if the trustees are UK resident from the outset, they may take any capital gain the trustees make outside the UK tax net. This might be considered a loophole in the original legislation. Some current EOT trustees are resident offshore. New EOTs should consider this potential change when making trustee choices.

If the prohibition on offshore trustees was to be embodied in legislation, monitoring the residence of trustees or directors of trustee companies will be essential. With more flexible and remote working arrangements available to employees, and with more businesses trading internationally, appointing an employee from, say, a US subsidiary onto the trustee board, or appointing an employee working from their home in, say Bulgaria, could trigger a disqualifying event with similar implications to those noted above.

Distributions, funding and clearances

The 2014 legislation for EOTs was limited in its scope, and the interaction with pre-existing legislation has led to uncertainties or inconsistencies, often relating to funding methods with which to establish an EOT.

An EOT trustee will hold shares as part of the trust fund but rarely does the EOT have cash reserves. Initially, all funds introduced into the EOT will be used to buy the shares. As a majority shareholder, the trustee could receive dividends but these

would be taxable so dividends are usually waived. Such waiver does not breach the control requirement to be entitled to 50% of the profits available for distribution (TCGA 1992 s 236T(3)). When EOT trustees need funds, the underlying trading company usually makes gifts or cash contributions.

A concern has been that these contributions fall within the broad statutory meaning of distributions in CTA 2010 s 1000. HMRC has tended to give clearances on this point. In the consultation, it is proposed to clarify in the employee ownership legislation that contributions made to pay deferred consideration to former owners will not be a distribution. This would be extended to include contributions to fund any associated stamp duty and interest liabilities. Such a change is welcome but it would remain the case that further contributions – for example, to pay trustee expenses, running costs such as preparation of accounts, annual tax returns or even tax due – could still be treated as distributions.

An alternative to cash gifts or contributions might be for the trading company to make a loan to the EOT trustees. However, this has the practical problem that unless there is a future sale of the shares, the EOT trustees would have no means to repay the loan. In addition, as the EOT trustee will be a participator in a close company by virtue of holding over 50% of the issued share capital (CTA 2010 s 454), such a loan would invoke the familiar liability for the underlying company under CTA 2010 s 455. That legislation seems inappropriate when it is applied to EOT arrangements.

Even if there is no loan, there have been concerns that the targeted anti-avoidance legislation in CTA 2010 s 464A might apply to contributions as being arrangements conferring a benefit on the EOT trustees as a participator. In the consultation, HMRC has made it clear that this targeted anti-avoidance rule will not apply if there is no tax avoidance purpose. However, it has confirmed, in particular, that it will no longer provide clearances on the application of s 464A.

HMRC was completely silent on the other key clearance for establishing an EOT, being clearance under Income Tax Act 2007 s 701 that the sale did not have a main purpose of obtaining an income tax advantage. This remains an area where participants in the EOT transaction can seek comfort from clearance in advance that HMRC will not issue a counteraction notice.

Funding the EOT could also create a theoretical inheritance tax liability. Section 13 of the Inheritance Tax Act 1984 seeks to prevent 5% participators in a close

company from avoiding inheritance tax by making transfers of value via the employee trust. Broadly, those participators must be excluded from benefiting under the trust deed unless they are fully liable to income tax on any benefit. If not, the transfer of value can be attributed to the shareholders in the company and, as a result, a specific exclusion is usually found in the employee trust documentation.

This is one area where legislation was amended in 2014 to accommodate EOTs, so that IHTA 1984 s 13A provides that funding a trust meeting the trading requirement, the all-employee requirement and the controlling interest requirement will not be a transfer of value. However, trusts can last a long time and the company's trading status might change or control might be lost during the trust period. As a result, the exclusion of 5% participators from benefiting under the trust to ensure the conditions of s 13 are met is still needed for an EOT.

Looking forwards

HMRC and the Treasury have published two calls for evidence and a consultation in respect of employee ownership plans and trusts, backed up with some round table meetings, gathering plenty of responses. The consultation states that the government is committed to support employee-owned companies across the wider economy and encouraging companies to transition to employee ownership, suggesting that no major revision of the legislation is proposed.

All simplification or clarification of the legislative burdens for companies would help EOT trustees, companies and employees to navigate the rules, though it seems likely that it would result in additional legislation and, meanwhile, many technical concerns remain unresolved.