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Specialist in Employee Share Ownership and Reward Management, Management Buyouts, Share Valuation and Investment Education

A Presentation

by

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for White Paper Conferences

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9 Halkin Street, London, SW1X 7DR

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Employee Benefit Trusts ("EBTs")

<u>The Question</u>

What are the latest ideas and innovations

around tax-efficient structures for EBTs and share awards

and why are they so significant?

Employee Share Ownership

What is the historic concept of the employee share trust?

- Historically the employee share trust is typically resident for tax purposes in an offshore jurisdiction, say for example Jersey or Guernsey or the Isle of Man. This is the arrangement that is created from the general legislation rather than bespoke legislation and is referred to in this presentation as "the historical employee share trust".

What is the history of this employee share trust structure?

- The origins of this structure lie in the solution provided by Louis Kelso in 1956 for Peninsula Newspapers, a company based in Palo Alto, California. The challenge was that the owner wished to retire and sell his shares to the employees while the employees, despite their willingness to buy, did not have the cash to enter into the transaction.

What is the significance of the Peninsula Newspapers case?

- The case established the basis for a management-employee buyout arrangement. The trust dispenses the shares to the employees through bona fide employee share schemes. However, the trust has a dual function in that it also buys back the shares from the employees for subsequent recycling when the employees sell. In the absence of a recognised stock exchange, the trust operates a market for the shares.
- The case also established the express linkage in the US between succession planning and pension provision for retirement as the employees sell their shares back to the trust on retirement.

How does the employee share trust work and what is the basis for financing?

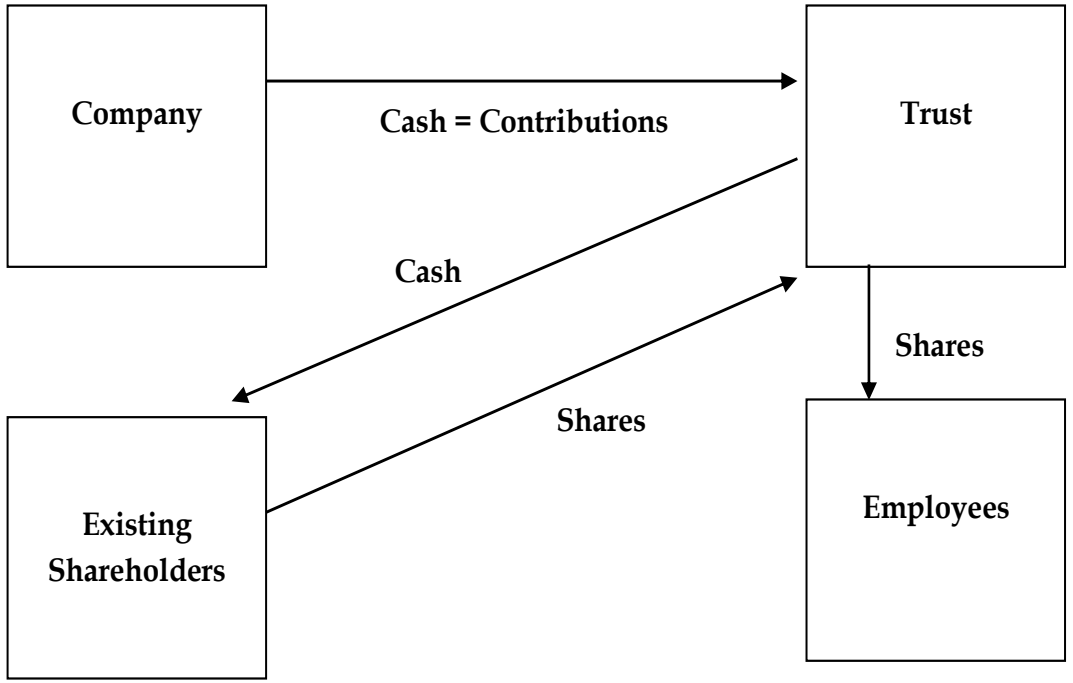
- The following set of seven diagrams depict the application of the key trust principles that operate for purposes of the arrangement and the financing techniques that are used to facilitate its operation. In the absence of a recognised stock exchange, the level of the finance is based on the allocation of recognised share valuation methodologies to determine the share price equivalent that is used in the transaction.

Employee Share Trusts

Diagram 1a: Company Funding through Contributions

How to Fund Free Shares: Company Contributions

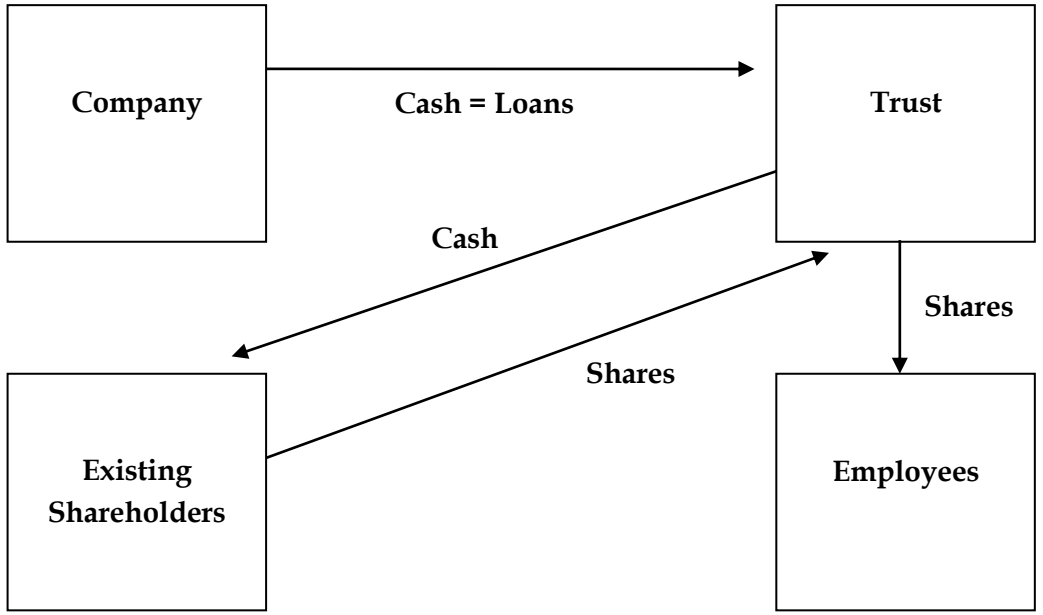
- If the company, rather than an external financial institution, is to fund the trust then the alternatives available are either funding through gift contributions or funding through loans.
- Where loans are advanced by the company to the trust, it is, of course, possible at a later stage for the company to make contributions to the trust so that with a circular movement of cash the trust in a position to pay off the loans.



Employee Share Trusts

Diagram 1b: Company Funding through Loans

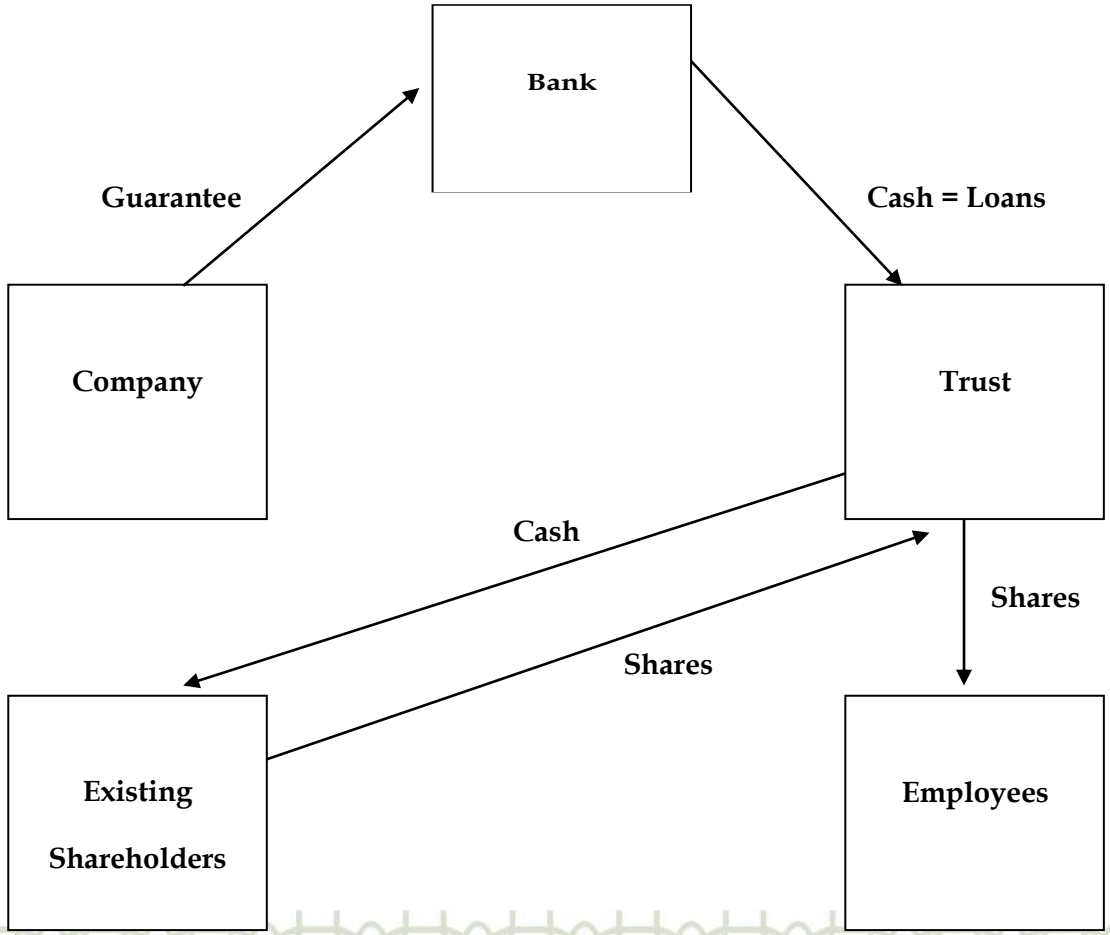
How to Fund Option Shares: Company Loans



Employee Share Trusts

Diagram 2: Bank Funding through Company Guarantees

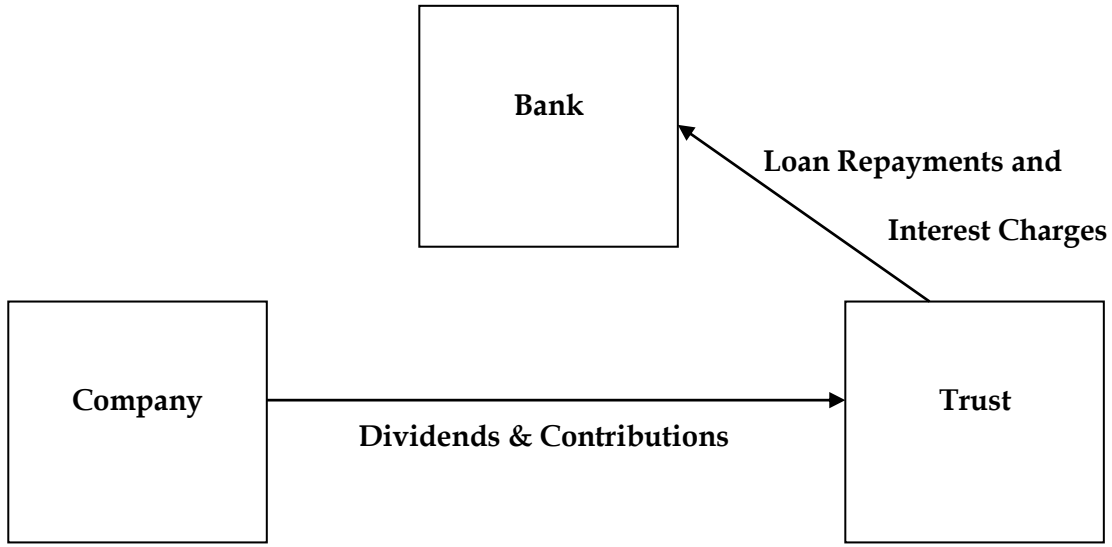
- If the company is "cash poor but asset rich" it may be necessary and possible for an external financial institution to fund the trust on the basis of guarantees given by the company. In these circumstances, both the company and the trust are parties to the agreement with the external financial institution.



Employee Share Trusts

Diagram 3: Funding the Loan Repayments and Interest Charges

- Where funding is obtained from an external financial institution, the trust will have to pay interest charges to the external financial institution. In these circumstances, the trust deed will not usually contain a dividend waiver so that dividends received on shares can contribute to the payment of the interest charges. The rest of the funding for the loan repayments and the payment of interest charges will derive from company contributions to the trust.

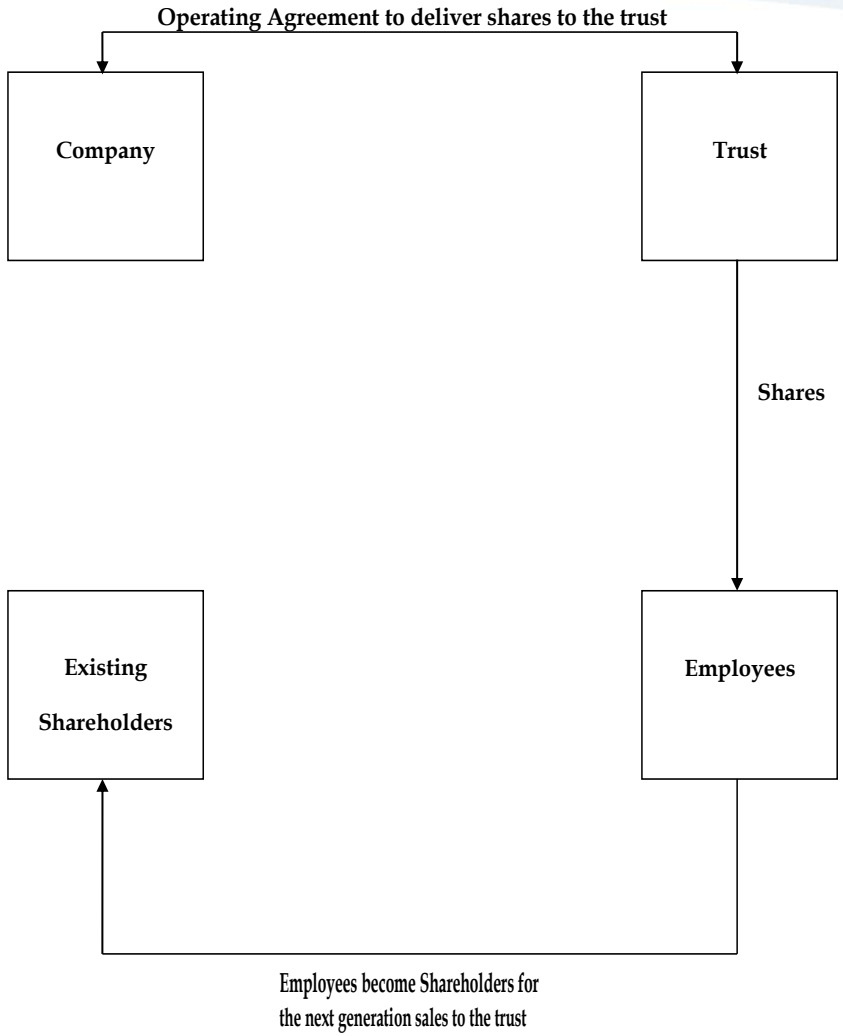


Employee Share Trusts

Diagram 4: Employees become Shareholders through the Transfer of Trust Shares

- Once the employees become shareholders through, typically, either the exercise of share options or an award of shares then, for purposes of selling their shares, they move in the diagrammatical representation from the bottom right-hand box to the bottom left-hand box.

- The illustrates the principle of how the shares are recycled from one generation of shareholders to the next generation of shareholders.

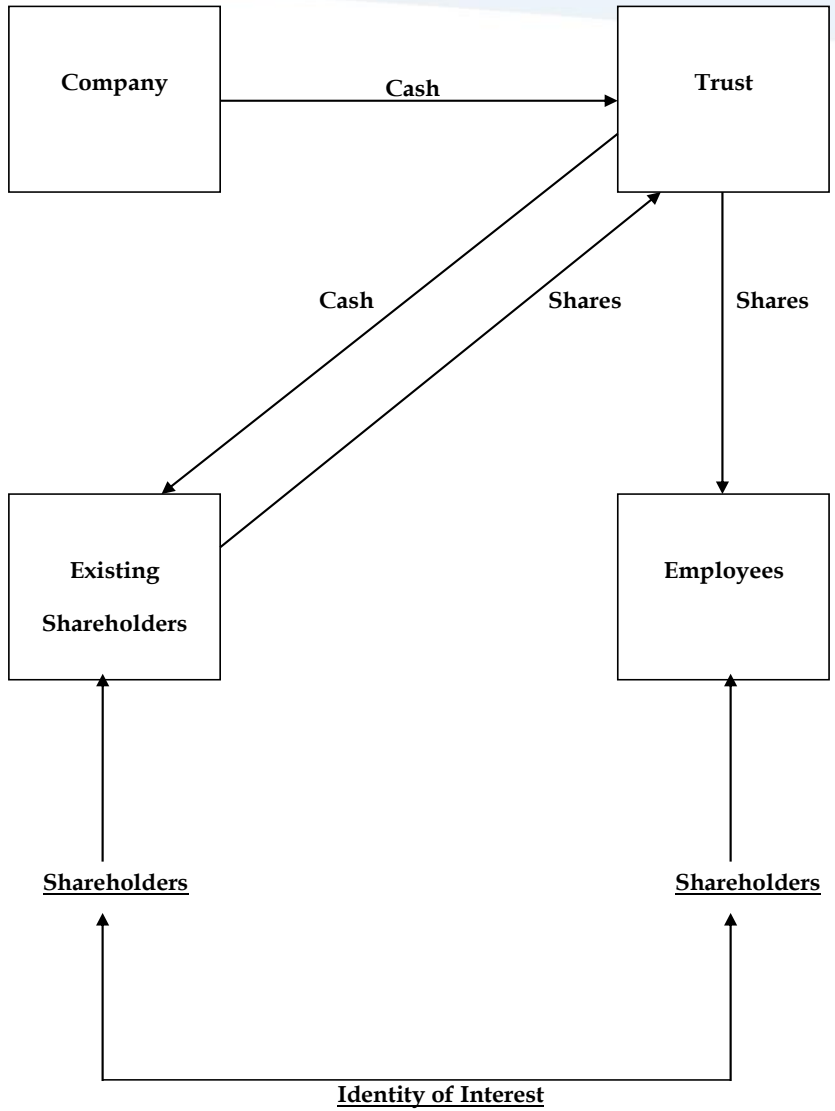


Employee Share Trusts

Diagram 5: Identity of Interest

- Although the term "identity of interest" is not a legal term of art, it is a well-established term in employee share scheme parlance. It is based on the principle that existing shareholders, through their shareholdings, and employees, through their share scheme involvement, unite around the totem of the share price/value in the interest of both parties wanting to see the capital growth of the company for the reason that both parties do, indeed, have an express interest in that growth.

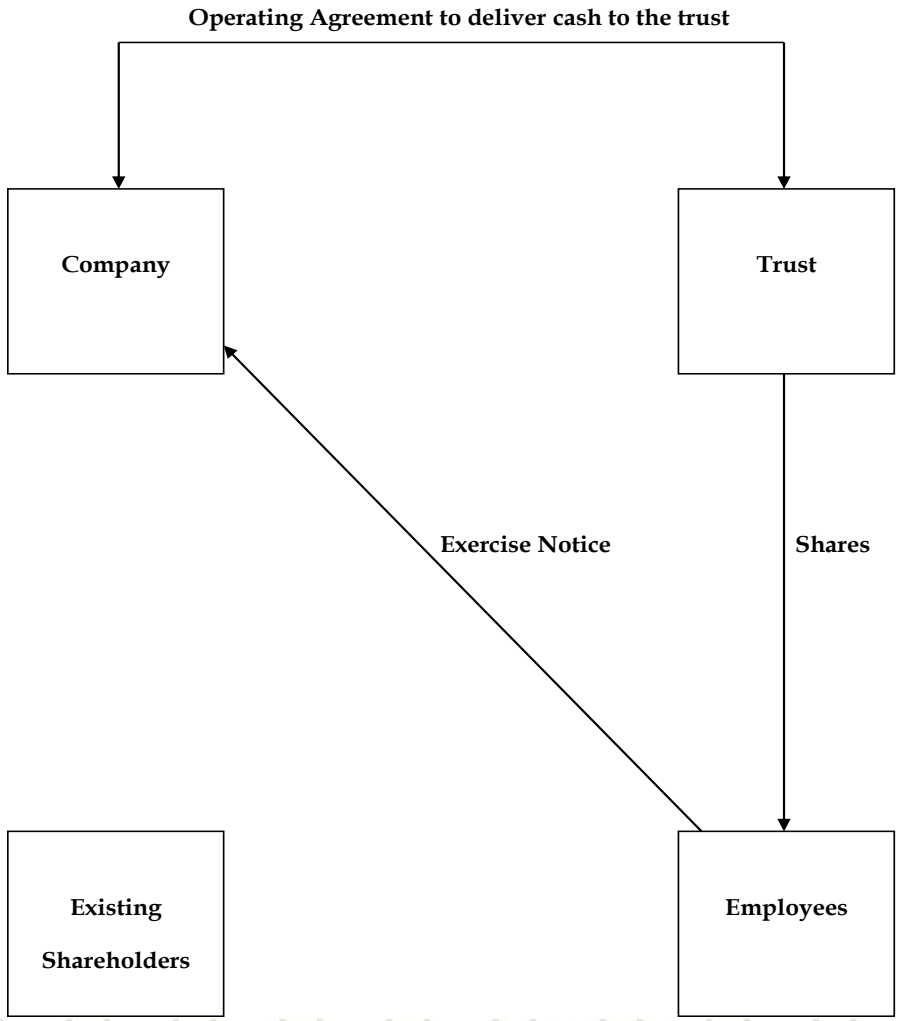
- The key principle that underpins the employee share ownership initiative is that employees are more likely to work towards the capital development of the company if they have an interest in the growth that supports the capital development of the company.



Employee Share Trusts

Diagram 6: The Operating Agreement

- The operating agreement or linking agreement (as distinct from the trust deed) governs the operating relationship between the company and the trust.
- Under the operating agreement, the trust agrees to dispense shares to the employees on the recommendation of the company, provided the company has arranged for cash to be supplied to the trust so that the trust is in a position to first buy shares that it will subsequently dispense.

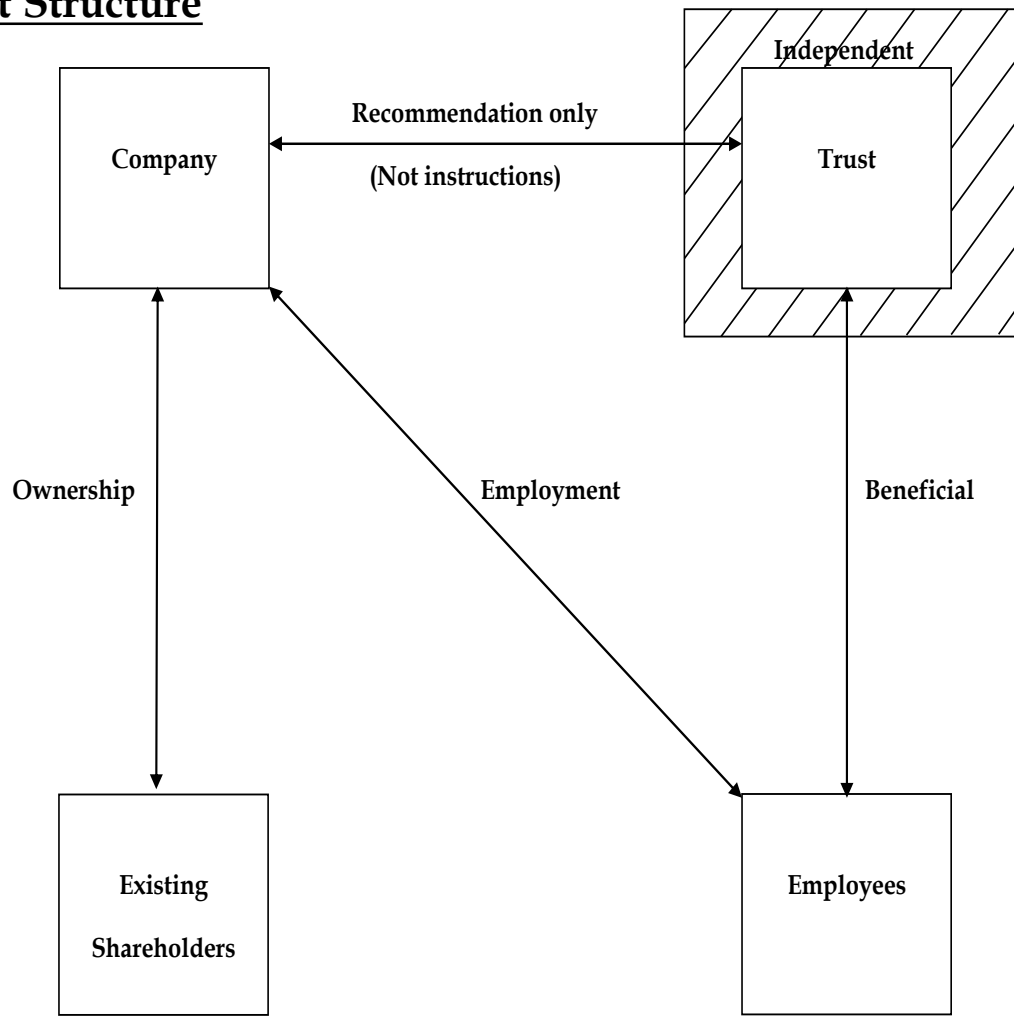


Employee Share Trusts

Diagram 7: The Relationship within the Trust Structure

- The company can provide recommendations to the trustees for use of trust property. However, these recommendations are not instructions and the trustees must operate as independent trustees, acting in the best interests of the beneficiaries.

- However, the company, as the settlor of the trust and the employer of the beneficiaries, must continue to be acutely aware of the decisions and the activities of the trustees.



Employee Share Ownership

What is the tax position for each party arising from this employee share trust structure?

- **For the company**

For the company, there is no corporation tax deduction on any contribution to the trust; rather under Chapters 2 and 3 of Part 12 of the Corporation Tax Act 2009, there is corporation tax deduction on the value of any income gain in the hands of the employee. The corporation tax deduction becomes a component of the company's business profit or loss for the year and is treated like any other deductible amount that has contributed to producing profits assessable to corporation tax. Under the Part 12 rules, the gain has the potential at least to be considerably higher than the actual cost of the purchase of the shares by an employee share trust for the reason that the gain represents a market-generated gain.

- **For the employee share trust**

For the employee share trust, given that the trust and the trustees are not resident in the UK, any sales, gifts or transfer of shares from the trust to any party are not subject to capital gains tax. There is no requirement, therefore, for the trust to be supplied with funds to pay a capital gains tax liability.

- **For the employees**

For the employees, the delivery of shares to them is through bona fide employee share schemes with whatever attendant tax reliefs are attached to those employee share schemes, either through the tax reliefs that arise from the tax-advantaged scheme in Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA 2003") or from the general tax legislation.

The shares are "readily convertible assets" under Section 702, ITEPA 2003 by virtue of the fact that the existence of the employee share trust in itself establishes "trading arrangements" in the shares. As a consequence, any income tax on employee gains is collected through the PAYE system rather than through self-assessment and National Insurance Contributions arise.

Employee Share Ownership

So enter the Employee-Ownership Trust ("the EOT") in 2014!

- Unlike the historical employee share trust, the EOT does have bespoke legislation. Introduced through Schedule 37, Finance Act 2014, it came into force on 6th April, 2014 through the insertion of new chapters into the Taxation of Chargeable Gains Act 1992 ("TCGA 1992") and the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA 2003").
- The inspiration for the EOT initiative appears to be the approach taken by John Lewis which historically has taken a different route to employee ownership than that which is encouraged by the tax-advantaged employee share schemes. The key feature of the EOT is the sale of the company's shares to a trust for that trust to hold the shares on a permanent basis and that clearly is inspired by the John Lewis model.
- Thankfully, though, the EOT does not preclude the operation of the tax-advantaged employee share schemes. Nevertheless, it is important to state that the EOT is a self-contained mechanism for achieving its dual purpose of facilitating a capital gains tax-free sale of a controlling interest to an employee trust while also enabling the payment of income tax-free bonuses to employees by the company.
- The EOT initiative offers a business succession model that has the capacity to operate as an alternative to a takeover trade sale of the business to an independent third-party acquiring company or a flotation on a recognised stock exchange. The prime motivation behind setting up the EOT is a combination of succession planning and securing the independence of the company. It is the case, though, that the EOT can be applied to start-up companies or, indeed, to companies at any stage in their development as indeed can wider employee share ownership in its many manifestations.

Employee Share Ownership

The Disposal of the Shares under the EOT

Under Section 236H, TCGA 1992, the EOT arrangement applies to a disposal of ordinary shares only where all of the following conditions are met:

1. A person who is an individual (rather than a company) becomes a vendor by disposing of ordinary share capital in the company to the trustees of a settlement.
2. There is full compliance with all the requirements for the tax relief.
3. The vendor makes a claim for the tax relief and includes in the claim information to identify the settlement, the name and the registered office of the company, the date of the disposal and the number of shares that have been disposed of.

When a disposal is made to the trust with all these conditions being met then the market value deeming rules under **Section 17(1), TCGA 1992** do not apply to the disposal.

For the purposes of the capital gains tax regime, the disposal by the vendor and the acquisition by the trust is treated as generating neither a gain nor a loss.

The key principle is that the following tax exemptions are available to a company when a 51% controlling share interest in that company is acquired within a single tax year by an EOT:

1. Capital gains tax exemption for a qualifying disposal of shares
2. Income tax exemption for qualifying bonus payments

Employee Share Ownership

The EOT Tax Exemptions

A. Capital Gains Tax Exemption: Qualifying Disposal of Shares

- A complete exemption from capital gains tax for the seller of the shares for the sale of the 51% controlling share interest to the trustee of the EOT in that defined single tax year. This exemption from capital gains tax is available for "qualifying disposals" by persons other than a company made to an EOT on or after 6th April, 2014.
- The exemption is available for persons who are not companies and, provided the set statutory requirements are met, notably that the shares are in a trading company or the parent company of a trading group, then the capital gains tax exemption is available to an unlimited extent. The fact that the exemption is unlimited is a very attractive feature indeed, even if the vendor has access to Entrepreneurs Relief for the simple reason that the sale of the shares to the EOT attracts zero capital gains tax on an unlimited amount.

B. Income Tax Exemption: Qualifying Bonus Payments

- A complete exemption from income tax for employees on bonuses paid up to £3,600 per tax year by a company that is owned by an EOT to all "qualifying employees" on a basis that meets the definition for "same terms". This exemption from income tax is effective for bonus payments that are made on or after 1st October, 2014.

Employee Share Ownership

How do the rules on close companies impact in the employee share trust and on the EOT?

A. What are the implications of the rules on loans to participators for close companies?

- An employee share trust will, typically, be funded either by way of loan or by way of direct gift contribution. If the funds are provided by way of loan then the provisions of Section 455, CTA 2010, (previously Section 419, ICTA 1988) need to be considered. This provides that where a loan is made by a close company to a participator then unless it is repaid or waived within nine months following the end of the accounting period in which the loan is advanced a charge equal to 25% of the loan becomes due and is payable as a form of "shadow advanced corporation tax". The company can in due course recover this amount as and when the loan is repaid by means of a claim for relief from corporation tax. Similarly, relief can be claimed at the point that the loan is written off although other tax charges might then arise under the inheritance tax provisions. However, the liability to pay this amount can cause a cash flow disadvantage for the company since it could be several years before the loan is eventually repaid or released.
- The charge to tax arises only in circumstances where the recipient of the loan is a participator. If, therefore, the employee share trust does not have any shares in the company or has a stake of less than 5% it will not rank as a participator for these purposes. Even where it is explicitly the case that the funds are intended for use in the acquisition of shares some advisors would argue that the employee share trust is not a participator when it receives the loan although it becomes one as soon as it uses the loan to acquire a substantial shareholding. It is important to be aware that HMRC will usually contend that the employee share trust is a participator where loan funds are provided from the company for the acquisition of shares.
- If the employee share trust is funded by direct gift contribution of funds from a company (and not by way of loan) then no charge will arise under Section 455, CTA 2010, (previously Section 419, ICTA 1988) although there could be a charge to inheritance tax under Section 13, IHTA 1984 or Section 28, IHTA 1984.

Employee Share Ownership

B. What are the implications of the inheritance tax rules for close companies?

- The principal tax concern in relation to an employee share trust with a close company settlor is in relation to inheritance tax. As a general rule, an employee share trust that complies with Section 86, IHTA 1984, will not be subject to the usual discretionary trust inheritance tax regime. Relief from the ten-year anniversary charge on the value of the assets held within the employee share trust is provided by Section 86, IHTA 1984, whilst Section 13, IHTA 1984, deals with disposals by close companies to the employee share trust, Section 28, IHTA 1984, covers transfers by individuals to the employee share trust and Section 72, IHTA 1984, deals with property leaving an employee share trust.
- The benefit of the tax reliefs afforded by Section 13, IHTA 1984, and Section 28, IHTA 1984, on payments into the employee share trust can, however, be lost unless participators are prevented from taking any benefit from the employee share trust other than one "which is the income of the participator for the purposes of income tax". It does not matter whether any participator is intended to or does in fact receive a benefit from the employee share trust, i.e. it is the mere ability of the participator to benefit that is sufficient to cause the reliefs to be lost.
- Cash payments out of an employee share trust do not cause the benefit of the reliefs to be lost. However, most other types of benefit, including loans on favourable terms or the grant of share option rights which could be exercised at the time when the exercise price is at a discount to market value would not be acceptable. This is for the reason that although any such benefits would generate income tax charges on the recipients the amounts on which the charges are generated are not themselves considered to be income for tax purposes.
- The effects of falling outside the reliefs in Section 13, IHTA 1984, and Section 28, IHTA 1984, are that any contributions made to the employee share trust are treated as though they were chargeable transfers by the contributor, or, where the contribution comes from the company, all of the participators pro rata to their individual shareholdings. Although the quantum of any resultant inheritance tax charge may be small or non-existent, depending on the circumstances of the participators, the charges are fiddly to calculate and cause added administrative complexity. In order to avoid these difficulties, then, providing it is commercially acceptable it is advisable to limit the ability of participators to take benefits from the employee share trust to those matters that would be treated as income in their hands.

Employee Share Ownership

Are there any exemptions specifically for the EOT as distinct from the historical employee share trust?

In this context we need to examine: A. The Loans to Participators Rules and B. The Inheritance tax Rules

A. The Loans to Participators Rules: Section 455, CTA 2010 (previously Section 419, ICTA 1988)

- There is no exemption for the EOT from Section 455, CTA 2010 (previously Section 419, ICTA 1988). Indeed, it seems unlikely that HMRC will instigate any change on this matter as the provisions on loans to participators are regarded by HMRC as a key protection against the extraction of funds from a close company in a tax-efficient form.
- So, yes, Section 455, CTA 2010 very definitely applies to the EOT. The challenge for the EOT is, therefore, to ask the question: "How can the financing be arranged to enable the EOT to pay the purchase price of the shares?"
- The three main alternatives are as follows:

1. The EOT trustees could approach the bank with a view to borrowing although this may not be practical for an EOT that is sponsored by a small company.
2. The company could borrow funds with a view to making gift contribution funding to the EOT. In these circumstances, it is advisable to submit an advance clearance application to HMRC under Section 701, ITA 2007 in order to confirm that the proposed transfer of cash to the shareholder by the trustee company will be treated as a capital transaction rather than as an income transaction that generates a dividend payment. As a general rule of thumb, provided that the arrangement does not have as its main purpose or one of its main purposes the obtaining of an income tax advantage, HMRC will give the clearance that has been requested. The key point to recognise is that there is no exemption for the EOT from the Transactions in Securities rules in Sections 682 to 713, ITA 2007.
3. The vendor remains an unsecured creditor. (Further exploration of this point on the next two slides.)

Employee Share Ownership

The Loans to Participators Rules: Section 455, CTA 2010 (previously Section 419, ICTA 1988)

Further exploration on the theme of the vendor remaining as an unsecured creditor

- The point is that once the EOT has purchased the shares there may be no mechanism available to enable the EOT to have the funds to pay to the vendor the consideration that is due. For this reason, all or part of the consideration due may remain unpaid until such time that the EOT has received sufficient funds from the company by way of one or a series of contribution payments. Contribution gifting will typically be the preferred approach in order to avoid the implications of the rules on loans to participators.
- With unpaid consideration in the immediate aftermath of the deal, it is the future earnings of the company that will be contributed to the EOT to enable the EOT to discharge itself of the obligation to pay the consideration. Monies, therefore, from future earnings can be released from the company without any charge to income tax or National Insurance Contributions although remember that contributions to the EOT do not qualify as deductions for corporation tax purposes. In contrast, payments made as emoluments, although subject to income tax and National Insurance Contributions, would be available for a corporation tax deduction.
- If the vendor remains an unsecured creditor then consideration should be given to the vendor remaining as a director of the trading company and being appointed a trustee of the EOT. It is worth noting also that the corporate trustee company of the EOT could be a subsidiary company within the group of the sponsoring entity.

Employee Share Ownership

The Loans to Participators Rules: Section 455, CTA 2010 (previously Section 419, ICTA 1988)

Further exploration on the theme of the deferred payment terms

- In practice, the vendor will have exchanged shares for an obligation by the EOT to pay the consideration, whether immediately or at some time in the future. If the deal is transacted on deferred payment terms, then that obligation may take the form of some form of loan note issued by the EOT.
- If the approach taken involves the issue of loan notes of a formal nature then it gives flexibility with the possibility of opening up and developing a secondary market in loan notes, subject to the completion of all due diligence procedures that conclude that there is no impediment to prevent the formation of a secondary market in the particular circumstances of the case.
- Indeed, the deferred payment terms are somewhat akin economically to an internal earn-out, maybe or maybe not linked to some agreement on the future performance of the company. If the company does not subsequently generate the future earnings to fund the payment of the consideration, then the EOT will not be able to fund the payment. Care, therefore, is required in evaluating the risk associated with a deal that involves deferred payment terms.
- Technically, there does not appear to any bar in the legislation to preventing the EOT from granting options even, as long as the shareholding does not fall below 51%.

Employee Share Ownership

The Loans to Participators Rules: Section 455, CTA 2010 (previously Section 419, ICTA 1988)

Further exploration on the theme of the deferred payment terms

- The contrast between this deferred payment terms approach and the approach adopted in the Peninsula Newspapers approach with the historical employee share trust is worth commenting upon as follows:

❖ **For the historical employee share trust under the Peninsula Newspapers case**

Where bank loan funding and immediate sale proceeds to the vendor: the company contributions are used to pay the bank

- For the historical employee share trust approach, the financial institution provides immediate funding, thereby enabling the vendor to be paid immediately.
- The contribution payments from the company to the employee share trust over a number of years are, therefore, then applied to the loan repayment and interest payments to the bank.

❖ **For the employee-ownership trust ("the EOT")**

Where no bank loan funding and deferred sale proceeds to the vendor; the company contributions are used to pay the vendor

- For the EOT approach where there is no financial institution to provide immediate funding, the vendor does not, therefore, receive immediate payment.
- The contribution payments from the company to the EOT over a number of years are, therefore, then applied to paying the vendor in one or a series of payments.

Employee Share Ownership

B. The Inheritance Tax Rules

An EOT is a Section 86, IHTA 1984 trust. However, by contrast with the Loans to Participator Rules, there are exemptions to the inheritance tax rules for the EOT that are not available to the historical employee share trust as follows:

- There is an exemption for "Dispositions by close companies to employee-ownership trusts" (i.e. EOTs only) in Section 13(A), IHTA 1984 for the rule relating to "Disposals by close companies for benefit of employees" in Section 13, IHTA 1984.
- There is an exemption for "Employee-ownership trusts" (i.e. EOTs only) in Section 28(A), IHTA 1984 for the rule relating to transfers by individuals to employee share trusts in Section 28, IHTA 1984.
- There is an exemption for "Property becoming subject to employee-ownership trusts" (i.e. EOTs only) in Section 75(A), IHTA 1984 for the rule relating to "Property leaving employee trusts and newspaper trusts" in Section 72, IHTA 1984.

Employee Share Ownership

How do the rules on distributions impact in the employee share trust and on the EOT?

- Section 1000(1), CTA 2010 includes in the definition of "distribution" "any other distribution out of assets of the company in respect of shares in the company,…"
- Given this wording in the legislation, The ESOP Centre in London requested further clarification from HMRC on its interpretation of this phrase in relation to a contribution to an EOT. It is understood that HMRC has indicated in a reply to The ESOP Centre that a contribution to an EOT will not be treated as a distribution under Section 1000, CTA 2010.
- Although the HMRC reply relates specifically to a contribution made to an EOT, it would appear reasonable to conclude that the answer would apply equally to the historical employee share trust.
- However, it is important to recognise that HMRC has not made any confirmatory comment in relation to circumstances in which the company enters into a binding obligation to make payments to either the EOT or the historical employee share trust, whether those payments are regular or otherwise. The point is that there cannot be a binding obligation for the reason that under general principles such payments would represent a source of income.

Employee Share Ownership

All Best Wishes For Your Business Initiative From David Craddock

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