Budget representation: Employee Ownership Trusts

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In a 2021 Budget representation, the CIOT has suggested options for limited legislative reform to the Employee Ownership Trust provisions to eliminate unnecessary costs, remove a potential Exchequer risk and enhance employee engagement.

The Employee Ownership Trust (EOT) tax legislation, enacted in FA 2014 as a result of the Nuttall Review, introduced capital gains tax (CGT) relief to remove the tax barrier of a 'dry' tax charge on the sale of shares by vendor shareholders to an EOT on a deferred payment basis (vendor funding). Inheritance tax (IHT) provisions also ensure that no IHT arises as a result of any disposal into an EOT; for example, at undervalue. In addition, the legislation provides for the payment of income tax-free bonuses of up to £3,600 per person per year to the employees of a company controlled by an EOT.

In a 2021 Budget representation on EOTs, the CIOT noted that although there remains strong support for the principle and the broad outline of the EOT reliefs, based on the experience of our members there are issues with the EOT provisions that appear to create costs for all parties, and pose a risk to revenue. The legislation only gives limited prompts to the employee engagement from which many of the benefits of employee ownership are understood to derive. We therefore propose that consideration is given to limited legislative change to address these issues. Our representation considers a range of options, subject to formal consultation, and sets out our favoured proposals.

Issue 1: the need for clearance where the sale is funded via deferred consideration

The first issue is the need for non-statutory clearances where, as is common, there is deferred consideration for the sale by the owners to the EOT.

In order to put the EOT in funds to pay down the deferred consideration owed to the vendor, payments are required out of profits of the trading company. Such payments by the trading company to its EOT are generally described as contributions. HMRC have indicated (through replies to non-statutory clearances) that they would not seek to tax such voluntary contributions as dividends in the hands of the trustees on the basis that the contribution is not a dividend received by a shareholder in its capacity as a shareholder. Instead, HMRC consider it to be a non-taxable contribution received by the trustee in its capacity as a trustee to achieve the purpose of the EOT.

The result is an uncertain situation where a payment that can only be made, as a matter of law, out of a company's distributable reserves, is not treated as if it were a dividend (distribution).

Our preferred option is for confirmation in the legislation that contributions paid by the target company to fund the acquisition are non-taxable in the hands of the EOT trustee/s, which should remove the need for unnecessary clearance activity.

Issue 2: the residence of EOT trustees

Currently, there are no restrictions on who may be a trustee of an EOT for it to qualify as such. This has the merit of not unduly limiting or distorting the choice of trustees. There is, however, anecdotal evidence of suggestions being made that EOTs should be established as non-UK resident trusts to avoid a future capital gain on shares in the target company, including instances of suggested planning where that second sale is in fact the primary commercial objective.

Therefore, the CIOT's representation explores whether conditions might be imposed to better prompt employee engagement, without undue downsides.

Our preferred option, again subject to formal consultation, is to amend the 'all-employee benefit requirement', which is central to the EOT's identity, to require the EOT's trustee/s to be resident in the UK.

Issue 3: should former owners and connected persons form a majority of the trustee board?

The key existing mechanism to promote employee engagement, namely the trustee's ability to influence the trading company's conduct, could in principle be enhanced by options such as requiring a majority of trustees to be unconnected with the vendor or imposing positive requirements as to the groups from which trustees would be chosen (employees, independents, etc.).

On balance, we think that (subject to consultation) a prohibition on former owners forming the majority on the trustee board achieves the best balance between allowing commercial freedom, while deterring and restricting opportunities for abuse and promoting steps that may assist in securing better engagement.

Claiming CGT relief

A further practical issue of immediate concern is the lack of a dedicated designatory code for making the claim for CGT relief for the disposal of shares to an EOT on the self-assessment tax return. Having a more clearly defined process for claiming the EOT CGT relief would assist compliance and help HMRC to track claims and numbers of EOTs.

Overall, we think it is the right time for a review of these provisions. We hope that the Budget representation, which can be read in full at www.tax.org.uk/ref853, will help to inform thinking on such a review.