Employment ownership trusts

Employment Tax



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William Franklin looks at the relative benefits of employee-owned companies

Key Points

What is the issue?

What is an employee owned company?

What does it mean for me?

How is such a company structured?

What can I take away?

In what circumstances might it be appropriate?

When future economic historians assess the long term effects of the Coalition government, it is possible they may one day conclude that the most lasting impact arose from some little noticed legislation in Sch 37 of the Finance Act 2014 (FA 2014). These are the provisions that introduced some new and relatively generous tax reliefs for employee-owned companies.

For these purposes an employee-owned company is a normal limited company which is run on a commercial basis. The key difference is that the majority of the shares are owned by a trust collectively for the long term benefit of the employees as a whole. To distinguish this kind of trust from other forms of employee benefit trusts (EBTs) the trust is normally known as an employee ownership trust (EOT). Employee-owned companies have indirect employee share ownership through the EOT.

In introducing these tax reliefs the government had strategic objectives. It wished to encourage the growth of what is sometimes called a ‘John Lewis economy’. John Lewis is the leading example of a UK business with this indirect employee ownership model. However, John Lewis is by no means the only example and there are many other companies with a similar ownership structure. After the financial crisis the government saw encouraging more John Lewis style companies as one possible way that could help rebalance the UK economy.

Advocates of the model argue that employee-owned companies display greater resilience to economic fluctuations, and certainly some of them have achieved a longevity and continued independent existence that is somewhat unusual for UK businesses. An association of employee-owned companies known as the Employee Ownership Association (EOA) exists to promote these companies and it has collected research into their economic performance which suggests that employee-owned companies often achieve a strong financial performance. In 2015 the EOA published some findings and these are summarised in ***Box 1***.

Image

BOX 1 - SUMMARY OF EOA RESEARCH FINDINGS FOR EMPLOYEE-OWNED COMPANIES	
Productivity and growth	**Resilience**
Productivity* Increased 4.5% year on year in employee-owned businesses. Productivity in the UK economy as a whole is flat *Capital Strategies 2014	Employee-owned businesses outperformed the market during the economic downturn
The employee-owned sector contributes £30bn GDP to the UK economy annually. *EOA 2012	Employee-owned businesses grew sales by 11.1% in the recession compared to non-employee-owned businesses which only grew by 0.6% *Cass Business School 2014
Operating profits of the Top 50 employee-owned businesses increased 25.5% *Capital Strategies 2014	The sales revenue of the Top 50 employee-owned companies increased by 4.6% year on year *Capital Strategies 2014
Employee numbers increased by 3.3% year on year in employee-owned businesses *Capital Strategies 2014	Employee engagement 80% of employee owners are happy to recommend their organisation as a place to work.
The number of employee-owned businesses is growing at an annual rate of just under 10% *EOA 2012	80% of employee owners experience a sense of achievement from their jobs. *Edinburgh Napier University 2012

Under FA 2014 Sch 37 it is possible for the owners of a company to sell their shares tax-free to an EOT. The sale must be for the majority of the shares so that the company becomes owned and controlled by the EOT.

After the EOT has acquired the shares, it may not have any funds to pay the consideration, and so it is not unusual for all or most of the consideration to be left unpaid until the EOT has received sufficient funds from the company that the EOT has acquired. This might be in the form of a loan by the company, but such loans can trigger tax liabilities under the loans to participators rules, so funding by gift tends to be the preferred approach.

In this scenario, from an economic perspective the purchase consideration is ultimately being funded from future earnings and this can make the arrangement attractive to an owner who wishes to retire. Future earnings that otherwise might have been taxed as income can be released from the business without income tax or National Insurance. However, this benefit is to an extent offset by the fact that gifts to fund the EOT do not qualify as deductions for corporation tax purposes, unlike employee remuneration which would be deductible.

A vendor of the company might, of course, have had the benefit of entrepreneurs' relief on a conventional sale of the shares and only have had to pay 10% tax on the gain anyway. So, while a tax-free sale is attractive it is unlikely by itself to be a sufficient reason for converting the company into an EOT ownership structure.

Tax considerations should only be a relatively minor factor in a decision to become an employee-owned company. The owners need to have compelling reasons for making such a fundamental change in ownership structure because once a company has become majority-owned by an EOT it is not easy to reverse the structure, as the trustees of the EOT have to act in the long-term interest of employees as a whole.

It is important that the owners think through how the corporate governance of the business will function after the company has become owned by the EOT, and there are many non-tax issues that must be addressed. For example:

- Who should the trustees be and how should they be appointed? It is normal for there to be a corporate trustee and for the corporate trustee board to include employee and independent directors.
- How should employees influence decisions? An employee council is often created that may advise and appoint employee trustee directors, but is it the intention that key commercial decision be referred to employees? If someone later wants to buy the company, should the employees have a vote or even a veto?

While a tax-free sale funded from future earnings has obvious attractions to existing owners who are exiting, indirect collective ownership may not be so attractive to future key employees, if they are denied the opportunity for capital accumulation through direct ownership of shares. However, the government thought about this and another advantage of Sch 37 EOTs is that up to 49% of the shares can remain in direct ownership. Tax-favoured share schemes, such as enterprise management

incentives (EMI) and share incentive plans (SIPs) are available as there are special rules for an EOT-owned company with a corporate trustee that set aside the corporate independence requirements that normally would prevent such tax-favoured schemes.

EOT-owned structures with direct shareholdings and or options over shares are often called hybrid schemes. They can appear to offer the best of both worlds, allowing the company to be put on the long-term secure footing of control by indirect employee ownership while allowing individuals to have direct equity participation. An internal market might be created with possibly a separate EBT acting as a company-funded market maker. However, there are issues that need to be carefully considered with such a structure. For example, what is the fair market value of the shares if EOT control means an external sale is highly unlikely? If share options or new shares are issued the company needs to be careful that the EOT's holding is not accidentally diluted below 51%, triggering clawbacks or other tax charges.

A case study that explores the potential tax and other issues that need to be addressed when a company considers moving to an EOT owned structure is set out in ***Box 2***.

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BOX 2 – EOT EXIT SCENARIO CASE STUDY

1. Business backgrounds

1.1 A privately-owned niche professional services firm with three owner managers each own one third of the equity. There are 25 employees including three senior managers.

1.2 Confidence in the continued existence of the business among customers is important, so maintaining continuity and succession planning is important to the success of the business today.

2. Personal goals

2.1 The owner managers want to retire or step back to less active roles over the next few years, and the three senior managers have expectations of becoming directors in the near term and possibly shareholders in the longer term. The owner managers would like the business to remain independent in the future but would like to realise some value if at all possible.

2.2 Many of the other employees have been with the business for years and make an important contribution and the owner managers would like to offer them new rewards and incentives.

3. Business prospects

3.1 The business is profitable and has a strong cash flow but as a people business and it has few tangible assets and so most of its value arises from its people who could leave and so it has limited goodwill.

3.2 The owner managers do not want to sell the business to a competitor and the current opportunities to do so are few and limited.

3.3 The business has potential because it occupies an unusual niche which possibly, one day in the future, could make it attractive to a larger business. However, this is very uncertain and at least several years away and in the meantime, the business needs to retain its people.

4. Remuneration

4.1 The owner managers are currently paid market rate salaries.

5. Possible future

5.1 The company could continue for a while without any changes but succession planning and concern about business continuity cannot be ignored. In a few years the owner managers might start to step back and retire and the senior manager might be promoted.

5.2 At this time, some of the shares owned by the owner managers might be transferred to the new directors. However, the new directors are not rich and would not be able to pay much for these shares. However, the owner managers should be able to qualify for entrepreneurs' relief and only pay 10% tax on the proceeds they do receive.

6. Questions

6.1 The owner managers wonder whether this is sufficient and the best option? Will it secure the long term future of the business and will the senior managers and other staff be happy?

7. Alternative Futures

Among the alternative futures are:

7.1 Conventional employee share options.

7.2 EOT-owned company.

7.3 Hybrid EOT-owned company.

7.4 Other employee ownership solutions or cash-based incentives.

8. Conventional employee share options

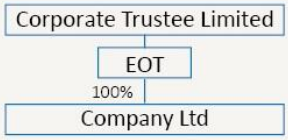
8.1 Options are flexible, do not involve an upfront tax charge or cost for the employee on award and can give a sense of ownership without the complexity of actual ownership for the company. But employees derive no actual financial benefit or influence until the options are exercised and shares acquired, at which point there are costs and tax charges.

8.2 Structured as EMI options the tax costs can be significantly moderated and there are corporate tax benefits for the company, but employees can derive no substantial financial benefit unless the business is sold and independence is sacrificed so, for a business that is seeking long term independence, this structure is of limited attractiveness. However, it could help to retain key managers and staff and prevent the business from imploding through key people leaving and so give the company breathing space.

9. EOT-owned company tax reliefs

9.1 FA 2014 Sch 37 relief could be a potential game-changer. The sale of a controlling majority of shares to an EOT is tax free for the shareholders and the company can pay tax free cash bonuses to employees up to £3,600 per annum. The resulting corporate structure for 100% EOT ownership might be summarised as follows.

9.2 The shareholders sell all their shares to the EOT (tax free) and the EOT owns all shares in Company Ltd and has a liability to the former shareholders for the outstanding consideration. Over time, as the earnings and cash flow of the business permits the EOT receives gifts of money from Company Ltd which allows the former shareholders to be paid by the EOT.



9.3 Income of the company that might have been paid to the directors as taxable salary or dividends might instead be gifted to the EOT to fund the payment of the consideration without being subject to tax. The gift will not be an allowable deduction for corporation tax so some of the money will need to be retained in the company to pay corporation tax.

10. A 'no brainer'?

10.1 Hardly. An EOT-owned structure involves creating a genuine employee-owned company and to succeed may need a different business culture.

10.2 Unravelling the structure afterwards is hard and so, if there were a future attractive offer from a third party, the owner managers might regret having sold the business to an EOT. There are tax clawbacks of the relief on an early subsequent sale of Company Ltd out of an EOT structure and the proceeds would have to be allocated to employees on an equality basis by the trustees, and there can be double taxation.

11. Different attitudes

11.1 The former owners who have benefited from tax free sale may see these disincentives for a subsequent sale as a good thing which will help preserve the company's independence. But what about the next generation of managers. Will they be so happy?

12. Other alternatives and ideas

12.1 Bank debt funding might help accelerate the process and a hybrid structure that involves options and direct shareholdings alongside the majority controlling EOT might be enough to satisfy key managers and give the founders a continuing stake and interest in the business.

12.2 There are less tax efficient but less restrictive non-Sch 37 trust arrangements that John Lewis and the other trail blazers used and other business models to consider such as LLPs and direct all employee ownership using SIPs.

Schedule 37 also provides another tax sweetener to encourage more employee-owned companies. The company (not the EOT) can pay tax-free annual cash bonuses up to a value of £3,600 per employee. This is a cash bonus, not a dividend, and so it can be paid without the company having to make a profit or have distributable reserves.

The EOT-owned company legislation does not exempt sales of shares into such structures from the transactions in securities rules set out in Income Tax Act 2007 ss 682 et seq. This means that the funding of the consideration paid by the EOT from future earnings generated by the company could potentially create an exposure under this legislation. Therefore, many companies will wish to obtain an advance clearance from HMRC that the transactions in securities provisions will not be invoked. If the sale of the shares is intended to create a genuine employee-owned company and the transaction is carefully explained to HMRC, then it is unlikely that it will withhold a clearance. The continued relevance of this legislation is likely to act as a deterrent to those who might seek to use the tax reliefs for potentially abusive purposes.

EOT-owned companies are not a complete solution and most owners and companies will probably not wish to make use of these tax advantages, but it is hoped that a significant minority of entrepreneurs and their advisers will at least consider the EOT route when considering exit planning.

Since the legislation was introduced growth in the number of companies in the sector has continued and appears to be modestly increasing. The model seems to appeal particularly to smaller professional service firms or other people businesses which need to retain good quality staff. Whether the changes will have the effect hoped for and the employee-owned company sector becomes a substantial part of the UK is something that may have to be left to the economic historians to decide.