Employee Ownership Trusts

Background

The Government made available a new form of trust in 2014, the Employee Ownership Trust (EOT), which provides a host of attractive tax reliefs. This new trust came from an earlier promise to further investigate employee focussed incentives, in a bid to assist companies in the recruitment, retention and motivation of staff.

Whilst an Employee Ownership Trust comes with clear benefits and incentives for the employees of companies that implement them – an EOT can also provide a very viable alternative for business owners looking to exit where there is no family succession planned or where the sale to a third party buyer is undesirable.

Qualifying Conditions

For the EOT to qualify for the tax reliefs the following conditions must be met:-

1. The shares in question must be in a trading company, or the parent company of a trading group
2. The trust must acquire a controlling interest (over 50%) in the company by the end of the tax year, being an interest which it did not possess at the beginning of that tax year
3. The trust which obtains the shares must operate solely for the benefit of all employees
4. The trust income and property must be applied on the same terms for all eligible employees
5. The person transferring shares to the EOT must not have previously qualified for any other tax relief on the same company shares (e.g. Entrepreneurs Relief)
6. Certain participators, broadly those that have had a 5% shareholding at any time within the 10 years up to the creation of the EOT, will be excluded from being beneficiaries of the trust
7. The proportion of participators (5%+ shareholders) in the company must not exceed 2/5ths of the total number of employees
8. The proportion of directors/office holders must not exceed 2/5ths of the total number of employees

Employee Benefits

Income Tax

Qualifying employees can benefit from the new EOT rules in Chapter 10A, Part 4 of the Income Tax (Earnings and Pensions) Act 2003 to received bonus payments of up to £3,600, which would otherwise have been taxed under PAYE, to be paid without incurring Income Tax charges.

While companies have some discretion to set bonuses as they see fit under an EOT, this payment must be a genuine bonus and not form part of the employees' regular salary or wage. Furthermore, there cannot be any arrangement whereby the employee forfeits some of their salary in return for this bonus payment.

The payments from the EOT must be made equally to all qualifying employees, but it is possible to flex these payments using measures of remuneration, length of service and hours worked to give a fair entitlement. Employees who have not met a minimum length of service requirement or who are subject to disciplinary proceedings can be excluded from receiving benefits from the EOT.

The equal treatment requirement means that the EOT cannot make loans to employees or make other discretionary awards.

The exemption from Income Tax does not extend to National Insurance Contributions and therefore bonus payments would still be subject to Class 1 Primary and Secondary contributions.

Shareholder Benefits

Capital Gains Tax

The rules in the Taxation of Chargeable Gains Act 1992 (Sections 236H-236U) provide beneficial relief for shareholders. This ensures that qualifying disposals of shares to the EOT will be treated as a disposal made at 'nil gain/nil loss' and so completely exempting the proceeds from Capital Gains Tax.

This relief may be an attractive proposal for many shareholders looking to exit and receive payment for their shares, and thus makes an EOT an interesting option.

Where finance for the share purchase is dependent upon company earnings or resources, it may be necessary to spread payment for the shares over several years. To ensure that the disposal qualifies for CGT relief in full the transaction may be structured to include loan notes to cover the deferred payments where necessary. However, bank finance may often be available to facilitate the EOT's share purchase, thus avoiding the need for deferred payments.

Inheritance Tax

An Inheritance Tax relief (Section 86 IHTA 1984) exists to ensure that the employee's entitlement under the EOT is not treated as relevant property within their estate. This ensures employees are not impacted should they die whilst a member of the EOT. This relief also ensures that the EOT assets avoid any of IHT charges that normally apply to the creation, 10-year anniversary and exit of assets from a trust.

Business Benefits

Corporation Tax

The tax-free bonus payments made to employees will represent 'qualifying benefits' under the employee benefit contributions rules (Corporation Tax Act 2009) ensuring that these payments will afford the employer company a Corporation Tax deduction for the bonuses.

Summary

The creation of an EOT helps to align the interests of the company and employees, encouraging employees to be motivated to work hard towards the company's future success. This may help improve both the productivity and profitability of the company, particularly as the EOT promotes long term stability of ownership of the business.

For the exiting shareholders, an EOT presents a unique opportunity to sell shares for their market value without incurring any tax charges. The EOT arrangement may be a cheaper and more straight forward route than a sale of the company on the open market.

The employees will also appreciate the opportunity to receive tax-free bonuses and to feel they have a direct stake in their employer.