EsopCentre Z/Yen

Response by the Esop Centre to the open consultation on taxation of Employee Ownership Trusts and Employee Benefit Trusts.

This response is from a representative body: the Employee Share Ownership (Esop) Centre is a non-profit subscription-based organisation which draws from over 35 years of experience to inform, research and promote direct employee share ownership in the interest of developing all forms of broad-based employee share ownership plans in the UK and Europe. Its membership includes accountants, administrators, bankers, brokers, consultants, lawyers, registrars, remuneration advisers, and trustees, alongside the companies that issue share plans to their employees.

The Esop Centre's submission is based on the response submitted by David Pett of Temple Tax Chambers (member of the Esop Centre's steering committee); many, though not all, of the points made having been endorsed by members generally.

Additionally, Esop Centre members have provided further review points on the policy objectives and assessment of the current state of the reliefs of Employee Ownership Trusts (see appendix 1, from page 16 of this document).

Chapter 3. Employee Ownership Trusts: Policy objectives and assessment of the current state of the reliefs

The stated policy objective, namely "*to encourage and incentivise the growth of employee ownership as a viable and mainstream business model*" and "[for trustees to be] *bound….to apply the trust property for the benefit of all the eligible employees*…." can be seen as more of a stated means to an end, rather than a policy end in itself. One has to ask: what ***is*** the benefit intended to be derived by individual employees from their employer company being owned and controlled by trustees rather than by any other investors? If the answer is that investment returns are intended to be enjoyed by employees as well as by financial investors, that is not in fact what happens, or is enabled to happen, by the legislation (s236H et seq TCGA 1992) as it stands.

Supporters of the indirect (trust) ownership model are keen to talk up its advantages, over other forms of private ownership, but are unable to explain how individual employees benefit financially from ***capital growth in the value of the business*** as compared with such other models. If the policy is "*to encourage the ownership and control of a business on a collective basis*", one has to ask to what end? The difficulty with the "John Lewis Partnership" model of collective ownership, through the use of employees' trusts, is that it is not apparent who benefits from growth in capital value of the company. (Quaere: what will happen to the ownership of The John Lewis Partnership if the trust period(s) comes to an end and is not extended by a private Act of Parliament?)

Under the existing regime, the ways in which individual employees are able to benefit personally from working for an EOT-owned company are limited.

(a) tax-free bonuses may be paid annually to all qualifying employees through payroll;

(b) the company could operate a tax-advantaged employee share scheme using newly issued shares (or shares purchased into a separate employees' trust from other shareholders) and adopt a mechanism for allowing leavers or those who wish to do so, to sell back their shares to any of (i) the company, (ii) the EOT or (iii) the separate employees' trust;

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(c) the company could pay dividends to the EOT which then distributes the net-of tax amount to beneficiaries (taxed as employment income); and/or

(d) the EOT trustee(s) could sell the company or its business and distribute the net-of-CGT proceeds to eligible qualifying beneficiaries (again, taxed as employment income).

If the underlying policy objective was to afford a tax-efficient means by which the individual proprietors of a company could realise the value they had generated and enable them to do so using the company's own accrued profits and reserves and without ceding control to a trade buyer or other investors, then the EOT regime may be counted a success. It has encouraged the disposal of shares in many private companies by its generous exemption from CGT. For those proprietors in a position to pass ownership and control to trustees, while preserving the ability of the business (at least until the consideration is paid in full) to generate profits sufficient to justify the price agreed to be paid by the trustee(s), the exemption means that a sale to an EOT – as opposed to a trade buyer or private-equity fund, etc. – is a "no-brainer" in terms of maximising the return on sale.

(A sale to an EOT for a consideration to be paid out of the distributable profits of the company, as opposed to a sale to a third party funded otherwise than by the profits of the company, raises the following conundrum: how can a company, valued at say £10m, be worth that amount to an EOT if that value will be reduced by the cash required to fund the EOT to pay the consideration? A company worth, say, £10m to a third-party purchaser cannot be worth that same amount to an EOT purchaser if the consideration reduces the assets of the company being sold.)

What, then, should be the underlying policy objective and how could that be achieved?

We suggest that the policy objective ought to be "*to enable employees to share in the growth in value of the business to which they contribute by their labour*". The current tax regime for EOTs does not achieve that.

In our members' experience, the most successful (in terms of resulting in substantial growth in value) private company ownership structures are those which:

(a) have enabled individual employees to benefit financially, from an appropriate share in the growth in value to which they have contributed by their labour over the period of their employment, and to do so in a manner which is taxed in the same way as if such gain was realised by a non-employee shareholder; and

(b) have a corporate governance structure which, while allowing the views of employees to be identified and taken into account, includes sufficient checks and balances to ensure that the directors are free to manage the business in the best interests of all shareholders.

So, in our opinion, the policy behind the tax legislation should be to balance the interests of company proprietors so as to offer them a financially viable alternative to selling the company to a trade buyer or to private-equity or other investors, with those of employees from time to time who should be enabled to benefit from the growth in value to which they contribute and to do so in a manner which is taxed no less favourably than if they were private investors and not employees.

As things have stood since 2014, the balance is firmly in favour of the vendor proprietors who are afforded total exemption from tax, and with little or no opportunity for employees (supposedly those persons for whose benefit the EOT regime was enacted) to benefit, other than by limited enhancement to their taxable employment income. It appears in some cases this results in the EOT route being viewed solely as a tax planning mechanism for vendors looking for an exit and may result

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in the EOT structure being used to create a favourable tax outcome for vendors, rather than with any real thought to the strategy, culture and governance structure required for a successful employee-owned business.

To redress that balance, we suggest the following changes:

1. Restrict relief from CGT for disposals of shares to an EOT to no more than the market value of the respective holdings of shares sold by claimants to the EOT.
2. Remove the tax-free annual bonuses and, instead, provide an exemption from income tax on the part of EOT trustees for dividend payments received from the EOT-owned company if:
   (a) the dividends are paid out to employees on an "all-employee and similar terms" basis; or
   (b) the dividends are retained by the EOT trustee(s) and applied (within, say, three years) in the purchase of shares in the EOT-owned company from employees who leave or who, with the agreement of the trustee(s) wish to sell having held such shares for a minimum period for a consideration which does not exceed the pro rata value of such shares determined by reference to the "market value" of the company as a whole as agreed with HMRC SAV (or certified by a recognised share valuer).
3. Provide that payments made to employees (and ex-employees who have left for whatever reason within the past 12 months), as described at 1(a) above, are taxed as dividend income, not as earnings.
4. Amend Chapter 3D of Part 7, ITEPA 2003 so as to provide that disposals of ordinary shares in the EOT-owned company beneficially owned by employees to the EOT for a consideration which does not exceed the pro rata market value, described at 1(b) above, is taxed as capital gain, not as employment income.
5. Allow ordinary shares in the EOT company to be appropriated to employees and/or sold to employees by way of awards under a tax-advantaged **Share Incentive Plan** (per Sch 2, ITEPA 2003) without that being a disqualifying event, ***and*** for so long as such shares are beneficially owned by individual employees and held in the SIP, allow those shares to be counted towards the percentage ownership of the share capital of the company by the EOT (so that the aggregate of such SIP shares, together with those beneficially owned by the EOT must not fall below 50% + 1 if a disqualifying event is to be avoided).

The combination of such changes, together with the changes to SIPs which have been separately suggested in response to the Call for Evidence on SIPs and SAYE share options, would enable an EOT-owned company to allow its employees to benefit directly from sharing in the growth in value of the EOT-owned company over the period of their employment in a tax-advantaged manner (within the confines of a SIP).

The suggestion at point 4 above would afford a commercial freedom to allow an EOT-owned company to enable its employees to benefit from such growth in value, subject to CGT, by way of other (existing) mechanisms for the acquisition and disposal of employee shares (such as the grant and exercise of EMI and CSOP, as well as "unapproved" share options, to subscribe for new shares or the operation of an internal market in employees' shares).

*Further review points provided by steering committee member, David Craddock, are listed in appendix 1 on page 16 of this document.

Chapter 4. Employee Ownership Trusts: Trustee issues

Question 1: Do you have any comments on the proposal to prohibit former owners and connected persons from retaining control of an EOT-owned company post-sale by appointing themselves in control of the EOT trustee board?

Vendor control

It is difficult to see why individual vendors of shares to an EOT should retain control of the EOT by way of being a majority of the trustees or having control of the board of a trustee company. Their expertise can be made available to the EOT-owned company by having the vendor retain a seat on the board of that company or engaged to provide consultancy services.

That said, vendors who sell on a deferred payment basis have a legitimate interest in securing that both the EOT-owned company and the trustee(s) will take all appropriate steps to ensure that the EOT is put in funds to enable the balance of consideration to be paid sooner rather than later.

Deferred consideration is necessarily unsecured. Given that the EOT-owned company cannot (to avoid a charge to tax on receipts of the EOT) be under a binding contractual obligation to put the EOT in funds, the vendors need to establish other means of ensuring that the board of the EOT-owned company gives precedence to funding the EOT over other application of profits. We have found that this is the principal, if not the sole, reason why vendors are keen to retain control of the EOT and of the EOT-owned company at least until they are paid in full.

Such control by the vendors can be achieved in a number of ways, such as:

- acting as the individual trustees or trustee directors and ensuring that (a) they comprise a majority and (b) that decisions of the trustees or the trustee directors, are taken by a simple majority;
- retaining a "golden share" in the EOT-owned company which affords the holder(s) a form of negative control of the EOT-owned company;
- remaining as directors of the EOT-owned company and ensuring that they comprise a majority of the board;
- including as a term of the sale and purchase agreement of the shares a provision which imposes a contractual restriction on expenditure by the EOT-owned company (including the payment of tax-free bonuses) so as not to impair the ability of that company to fund the EOT.

Question 2: Should the government go further and require that the EOT trustee board includes persons drawn from specific groups, such as employees or independent persons? If so, how should these groups be defined?

The need for independent trusteeship

Given the inherent conflicts of interest of vendors, managers and trustees/trustee directors, EOT trust deeds necessarily include provisions which authorise decision-making by trustees/trustee directors notwithstanding the fact that they might have distinct and conflicting roles and personal interests.

Is there not a case for including, as a relief requirement, both (a) a provision that the trustees/trustee directors must include one or more individuals (or trustee services organisations) who are independent of the EOT-owned company i.e. are not and never have been an officer or director, or 5%+ participator in, that company and any associated company **and** (b) a further provision that resolutions of the trustees/trustee directors may only take effect with the positive consent of at least one such independent trustee/trustee director. [See, by way of example, paras 3-3C of Sched 5, FA 1989 – re trustees of QUESTs.]

Compulsory inclusion of employees as trustees/trustee directors

Such a provision was not a success when legislated for in relation to QUESTs – see Sched 5, FA 1989. It is surely a commercial matter for the company concerned and its proprietors (and/or the trustees) to determine, as a matter of corporate governance, whether and to what extent individual employees who are not themselves officers or shareholders should be appointed as trustees or trustee directors and, if so, how they are to be selected, nominated, appointed and removed (etc.).

The corporate governance structures of an EOT-owned company

In establishing the checks and balances between the trustees/trustee directors, the vendors, the directors of the EOT-owned company, other shareholders, and employees, guidance is provided – and is often looked to as a starting point – by the Model Documentation for a Company with Employee Ownership, published in 2013 by the Department for Business and still available at : https://tinyurl.com/7vzdzuwm .

It is regrettable that HMT and the successor to the Department for Business have not liaised and commissioned and published updated model documentation suitable for use in relation to an EOT. The Esop Centre asks if this could now be done, please.

Question 3: Do you have any comments on the proposal to require that the trustees of an EOT are UK resident as a single body of persons?

Trustee tax residency

The Channel Islands' trustee service is an integral part of the UK share plan framework, and our CI trustee firm members tell us that the majority of their new business comes via UK introducers on the basis of their knowledge and experience, so would argue that to deny access to the expertise of non-UK resident trustees is detrimental to the wider share plans sector.

The inclusion of a non-resident individual, as a trustee director, does not mean that the trust is itself outside the scope of the charge to UK CGT.

Chapter 5. Employee Ownership Trusts: Funding issues

Question 4: Do you have any comments on the proposal to confirm in legislation the distributions treatment for contributions made by a company to an EOT to repay the former owners for their shares?

Allowing loan funding by the EOT-owned company to the EOT

The commercial imperative for vendors to retain control would be lessened by allowing the EOT-owned company to advance money on loan to the EOT without that giving rise to a charge to tax under s455 CTA 2010 ("loans to participators"). This would allow the EOT-owned company to obtain

a bank loan (secured on the assets of the EOT-owned company) which could be applied in making a loan to the EOT, allowing it to pay the agreed consideration to vendors in full. This would have the following consequences:

- It allows the purchase by the EOT to be more easily externally funded and affords greater transparency in a determination of the market value of the shares being sold (as the value of the company must reflect its debt obligations).
- It allows the vendors to "walk away", having been paid in full up front, and therefore having no commercial need (other than safeguarding the future of the business) for retaining control of the EOT or the EOT-owned company (which avoids the BPR issue identified below).
- If such a loan by the company to the EOT is free of interest and left outstanding, the company's debt to the bank can be paid out of funds generated by the business without the need for funds to pass up through the EOT.
- It would make it easier for bank funding to be obtained as banks are more reluctant to lend to the EOT itself (if the funds advanced are immediately paid out to the vendors) even if they can take security by way of a charge over the shares held by the EOT as, again, there can be no binding obligation on the part of the EOT-owned company to put the EOT in funds to service the debt of the EOT and, in any event, contributions to the EOT can only be made out of distributable reserves of the EOT-owned company.

While recognising the reluctance of HMT and HMRC to make any exceptions to the effective prohibition on loans to participators, we believe it would be relatively straightforward to provide safeguards by restricting any such loan to the initial market value of the shares purchased by the EOT or, if less, the aggregate and specified amount of consideration agreed to be paid for them, and the stamp duty/SDRT thereon.

Legislating for contributions by the EOT-owned company to the EOT, up to the amount of the lesser of market value of the shares acquired and the consideration agreed to be paid (plus stamp duty/SDRT thereon), to be exempt from tax in the hands of the EOT trustee(s)

HMRC's long-standing practice of not treating contributions to the EOT as taxable distributions was first confirmed to the Esop Centre by Dr Victor Baker of HMRC at a meeting in February 2017. Dr Baker confirmed in a letter dated 8 May 2017 that it was his intention to amend the HMRC Company Taxation Manual to reflect this, but this has never been done.

While we accept that there is a good policy reason for restricting this practice to EOTs which have paid no more than market value for a controlling interest in the company, it is difficult to see why the treatment should be confined to EOTs, as opposed to other forms of employees' trust intended to be used to hold a controlling interest in a trading company. Perhaps for this reason it would be preferable to amend the published guidance to reflect the practice of HMRC rather than make a legislative change which applies only to EOTs?

Allow Business Property Relief from inheritance tax ("BPR") for unsecured vendor-loan funding

Our members are aware of a number of situations in which a transfer of ownership of a company to an EOT has been vetoed by elderly shareholders concerned at the loss of BPR when exchanging shares for an unsecured debt obligation by the EOT trustee(s) for the deferred consideration. This has the effect of discriminating against older individual shareholders whose estates will suffer disproportionately if they die before the consideration is paid in full.

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Clearances in respect of the application of section 464A of the Corporation Tax Act 2010 to contributions made from the company to the Employee Ownership Trust

Question 5: Do you have any comments on the proposal that HMRC stops giving clearances on the application of section 464A of the Corporation Tax Act 2010 to the establishment of EOTs?

Applications for clearance that this provision would not apply have only ever been "for the avoidance of doubt". A change to the published guidance to make clear in what circumstances HMRC might seek to apply this provision in the context of an EOT would be welcomed.

Chapter 6. Employee Ownership Trusts: Income Tax Bonus issues

Question 6: Should the EOT bonus rules be eased so that tax-free bonuses can be awarded to employees without directors necessarily also having to be included, and would this undermine protections which ensure that bonus payments are not abused or weighted towards some employees?

The idea that the directors of the EOT-owned company should be entitled (unless restricted by the articles and/or the SPA) to award tax-free bonuses to all qualifying employees each tax year has always seemed perverse, at least from a policy point of view. We understand that it came about because, the wrong question was asked of the wrong decision-makers (finance directors having been asked if they would find it easier to administer payments to employees if they were to be made through the payroll – to which the obvious answer was "yes").

Allowing control of such payments to employees (not being linked to profit) as a payroll expense sets up a tension between the directors of the EOT-owned company (who may see immediate HR and incentive benefits in making such payments) and the trustee(s) who may prefer the money to be applied in making a contribution to the EOT to enable it to satisfy outstanding consideration due to vendors. Further, such payments can be made notwithstanding that the business is loss-making, so they are not necessarily payments by way of sharing in the growth in value to which employees have contributed.

We suggest that, logically, it would be preferable to afford exemption from income tax on the part of EOT trustees for dividends paid by the EOT-owned company, provided that such dividend income is distributed to employees (on an "all-employee, same terms" basis) within, say, 30 days, and for such payments to employees to be treated, for tax purposes, as dividend income, not as employment income.

Such payments to employees need not be capped in amount as they would be dependent upon the EOT-owned company generating the profits required to fund the dividends. It would allow employees to benefit from the value they help create by participating in profits in a manner which is taxed on the same basis as other individual shareholders of a private company. There would in principle be no loss to HMT as the payments would not (as they do at present) reduce the profits of the EOT-owned company for corporation tax purposes.

The flexibility to exclude directors and other officers from participation in bonus payments would be welcomed.

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Question 7: Do the EOT bonus rules create any other unintended consequences or challenges in administering the tax-free bonus payments?

Overseas employees - What is the policy reason for insisting that employees outside the charge to UK income tax must be included as participants in a (UK) tax-free bonus distribution? Typically, they would be taxed in the country of residence and so there is no obvious benefit to them in receiving the bonus under such a scheme of distribution intended to secure UK tax benefits. It also gives rise to difficulties where:

- the relative value, in terms of the buying power of a given amount, of the payment differs from one jurisdiction to another and this leads to unfairness as between employees around the world;
- differences in local employment laws mean that it can be difficult to identify exactly who is to be treated as an employee for this purpose: an individual taxed as an employee in one jurisdiction may not be an employee for UK tax purposes, and vice versa.

For these reasons, we suggest that the payment of tax-free bonuses be limited to employees whose earnings are charged to UK income tax because they are resident here or they perform duties in the UK. This would greatly simplify the administration for those EOT-owned companies with overseas employees.

Question 8: In addition to the reforms proposed at Chapters 4 to 6, do you have any views on ways the Employee Ownership Trust tax regimes could be reformed to better support employee ownership?

CT relief for share option gains

There is no CT deduction available to an EOT-owned employer company on the exercise of share options by employees of an EOT-owned company (unless the trustees are all individuals). Was this a deliberate policy decision or an accidental omission?

The EMI share options "trap"

Prior to 2014, it was not uncommon for trusts established to acquire indirect employee ownership of a company to have, as a sole corporate trustee, a company with a share capital which is directly wholly-owned as a subsidiary of the trust-owned company. Such circularity of ownership (i.e. the trust owns the company which in turn owns the trustee) had a number of commercial attractions including the ability to build into the corporate governance structure a range of "checks and balances" to ensure that no one group of interests (vendors/ trustee(s)/trustee directors/ directors of the trust-owned company and its subsidiaries/ employees) could take effective control of the ownership and control of the company.

Although special provision is made in the legislation for EOT-owned companies to be able to grant EMI share options as rights to subscribe for new shares, an EOT with a corporate trustee with a share capital which is owned in this circular manner cannot grant EMI share options as the grantor company would not meet the "qualifying subsidiaries" requirement in Sch 5, ITEPA 2003.

Allowing capital distributions to beneficiaries to be taxed as capital gains, not employment income.

It does seem contrary to the presumed policy intention of allowing employees to benefit from capital growth in value of an EOT-owned company that, if the company or its business is sold and the net proceeds distributed to beneficiaries, these are taxed as employment income, not as capital gains.

Why should employee beneficiaries of an indirectly "employee-owned" company be taxed in a manner which is substantially worse than that of individual direct share owners? We say "substantially" because the effect of the CGT clawback charge on the EOT trustee(s) coupled with the net proceeds being charged to income tax and NICs in the hands of the beneficiaries, means that growth in capital value of the shares held by the EOT is effectively subject to double taxation.

Allow ex-employees who have contributed to growth in value to participate in distributions

Presently, unless the EOT-owned company or its business is sold, ex-employees cannot participate in a distribution from the EOT. This is grossly unfair. There are many situations in which a long-serving employee who has contributed to growth in value retires, as anticipated, shortly before a distribution and is then excluded notwithstanding that his or her contribution to that value creation far exceeded that of more recent joiners.

The class of beneficiaries in whose favour the EOT trustee(s) should be permitted to (and must) exercise their dispositive powers should be extended to include former employees (including the personal representatives of deceased employees) who have ceased employment within, say, the past three years and who had a qualifying period of continuous employment which is no less than that applied to current employees.

Restricting CGT relief to exemption from CGT on gains representing consideration of an amount not exceeding the market value of the holding of shares sold

It is perhaps surprising that this was not included in the 2014 legislation. Thought is needed as to whether the restriction on relief should be by reference to market value determined on a pro rata basis or upon the lower market value of each holding of shares respectively sold by each vendor. The trustee(s) have a duty under trust law not to acquire the shares for a consideration which exceeds the market value of the aggregate holding acquired (and to be confident of their ability to meet their contractual obligations in doing so). However, it seems overly generous to allow each individual vendor a complete exemption from CGT insofar as the consideration paid to him or her (on a pro rata basis) exceeds the market value as discounted from a pro rata value to reflect the size of the minority holding actually sold to the EOT.

Maintaining a balance between relief from CGT and public benefit

The complete exemption from CGT afforded to certain sales of shares to an EOT has the effect of inducing the establishment of EOTs and the sale of a controlling interest to the trust solely, or primarily, to secure the tax relief. If the consideration agreed to be paid by the EOT (an amount which, in practice, is often determined on a "generous" basis) cannot in fact be funded out of distributable reserves and profits generated in future, the fact that the trust deed and SPA will (or should) provide that the liability of the EOT trustee(s) is on a "non-recourse" basis (i.e. they are only liable to pay deferred consideration if and insofar as the trustee(s) is in funds to enable it to do so and there is no recourse to the trustees personally or to the EOT-owned company) means that vendors can, in effect, fix the consideration at a level at which they can "milk" the company to the extent that it is able to generate distributable profit. If and insofar as it cannot or does not, the vendors are no worse off than if they had agreed a lower consideration, which could be funded by the company, in the first place. The vendors are in the position of "heads they win", but "tails they do not lose".

Put another way, it might be said that the regime is self-policing in that, only if the company can generate the profit will the vendors be paid, but the effect is to encourage values being ascribed to shares in a company which in other contexts would be hard to justify. (See also the point made above

about the valuation conundrum where the consideration is funded out of the assets of the company rather than from the pockets of a third-party purchaser.)

We would suggest that the relative attraction of the tax relief could be eased, so as to encourage a more balanced approach to proprietors deciding whether to sell to an EOT or a trade purchaser or other third party, if the relief were limited to a reduced rate of CGT, rather than complete exemption.

Counting shares awarded by the EOT, out of its 51%+ holding, to employees under a SIP to count towards the 51%+ holding, which it must maintain to avoid a "disqualifying event"

Except insofar as shares first acquired by the EOT in circumstances qualifying for the relief from CGT pass outside the confines of a circle comprising (a) the EOT trustee(s); (b) the company itself (in treasury); (c) employees with a beneficial interest in the shares held by SIP trustees subject to a SIP, the shares should count towards a 51% + 1 minimum holding to avoid triggering a disqualifying event.

This would encourage EOTs to enable employees to acquire direct beneficial ownership of shares while maintaining the "employee-owned" status of the company.

Going further and making the award of shares under a SIP a requirement of relief from CGT on sales to an EOT

It may be difficult in practice to do so, given that the number of shares available may not be sufficient to allow SIP awards to be made to all qualifying employees on a regular basis or at all.

Other enhancements to the EOT regime worthy of consideration

The existing regime would become more attractive to proprietors and employees if:

- there was an exemption from stamp duty/SDRT on sales of shares to an EOT (whether or not such share sales satisfy the CGT relief requirements;
- contributions by an EOT-owned company to the EOT were treated as deductible expenses for corporation tax purposes.

Chapter 7. Employee Benefit Trusts

Proposed changes

Question 9: Do you have comments on the proposal to confirm the government's position by making it explicit in legislation that the restrictions on connected persons benefiting from EBT must apply for the lifetime of the trust?

9.1 - First, we have seen within instructions received, a number of examples of tax planning for succession of ownership of a close company, based upon the opinions expressed by certain KCs, to the effect that death breaks any prior connectivity between a transferor and (typically) a child of the deceased transferor who is or has been an employee or director. If, therefore, the settlement terms grant the trustee power to exercise dispositive powers in favour of a member of the class of beneficiaries who, being an existing or former employee or officer of the body concerned, is not then so connected, such powers may (and are intended to be) exercised in their favour to the exclusion of other members of the class. The question of whether this interpretation is correct has not yet been the subject of judicial determination (and such an interpretation does appear to have been accepted by the GAAR panel – see Example D29), although, as mentioned in the Consultation document, doubt has been cast by members of the Court of Appeal.

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9.2 - Secondly, our members who are specialist advisers on employee share plans do not have any objection in principle to the idea of pre-empting any such judicial determination by amending ss13, 28 and 75, possibly with retrospective effect, so as to put beyond doubt that, to qualify for exemptions from inheritance tax, the trust must positively exclude from benefit (otherwise than in the form of income chargeable to income tax – see below) at any time – and specifically both when the disposition or transfer is made into the settlement ("**Time A**") and when the trustees exercise their dispositive power ("**Time B**") - any person who:

(i) ***is*** at Time B a participator in (a) the close company whose shares are or have at any time been held in the settlement, or (b) the close company which made the disposition to the settlement, or (c) any other company connected or associated with (a) or (b);

(ii) ***is*** at Time A or ***was,*** at any time in the period of 10 years before Time A, a participator in (a) the close company whose shares are or have at any time been held in the settlement, or (b) the close company, which is making the disposition to the settlement, or (c) any other company connected or associated with (a) or (b);

(iii) was a participator in any other close company which has made a disposition into the settlement, or was a participator in any such company at any time within 10 years before such a disposition is or was made;

(iv) ***was***, at or within 10 years *before* Time A, connected with any such person, or ***is*** *at* Time B, or has *at any time since* Time A, been connected with any such person.

Question 10: Do you have any comments on the proposal to only allow the IhT exemption where the shares have been held for two years prior to settlement into an EBT?

10.1 - It is difficult to support this proposal without understanding the policy reason behind it and the mischief it seeks to address – neither of which is explained in the Consultation document. We have seen examples of start-up companies whose founding shareholders have been anxious to "ring-fence" a proportion of the issued share capital for the benefit of employees and have formed an EBT for perfectly legitimate and understandable (non-tax) reasons very soon after the company was formed. The fact that a founding shareholder transfers into trust, a proportion of the shares for which he or she has subscribed, rather than put the trustee in funds to subscribe for shares, should not of itself disqualify the trust and its settlor(s) from the benefit of IhT reliefs.

10.2 - Again, if there is a company reorganisation or reconstruction as a consequence of which an investor begins to hold shares in a new holding company, why should that person then have to wait two years before a transfer of shares into an EBT qualifies for relief?

10.3 - We have not come across any example of tax avoidance, or tax planning, where the mischief (actual or perceived by HMRC) is, or might arise by reason only of, a transfer of shares into an EBT being made within two years of acquisition.

Question 11: Do you have any comments on the proposal that no more than 25% of employees who are able to receive income payments should be connected to the participator in order for the EBT to benefit from favourable tax treatment?

11.1 - The first point which requires clarification is the meaning of s65(5)(b) IhTA 1984. Specifically, what is the policy intent behind, or what is meant by, "income *of any person for any of the purposes of income tax*…."?

11.2 - In practice, it is understood that HMRC interprets this as meaning "*is actually charged to income tax in the hands of the recipient*". It is far from clear that this is correct.

11.3 - At one end of the scale, it could mean income in the trust law sense of regular receipts from a subsisting source. Alternatively, it could mean a receipt which would fall to be charged to income tax but for the availability of a relief or exemption (such as, for example, the availability of double taxation relief under the Disguised Remuneration rules). Is the acquisition of shares pursuant to an employee share option, giving rise to a charge to income tax under Chapter 5, Part 7 ITEPA, to be regarded as "*income for one of the purposes of income tax*"? It is a capital gain specifically charged to income tax.

11.4 - Surely, the policy debate should be whether, to qualify for IhT exemptions, participants and connected persons required to be excluded from capital benefit should nevertheless be permitted to take benefits in any other form, unless, perhaps, the full amount of benefit actually received or realised falls to be charged to income tax (and NICs?)?

11.5 - The proposal as framed in terms of there being a maximum limit, of 25%, on the percentage of employees (and officers?) who may receive benefits which are charged to income tax (if that is the effect of what is proposed) appears arbitrary and to have unintended consequences. Is this restriction intended to apply only to close companies whose shares are held in the EBT, or which have made a disposition to the EBT?

11.6 - At its simplest, a trust for the benefit of a large family-owned (close?) company (or group – see below) which has a large number of family members employed may find such a restriction to be unfair when compared with the EBT of another company employing an equal number of family members, but which has a larger workforce overall.

11.7 - In applying the proposed restriction, how is the fractional limit to be defined? Who, at any given time, is within the denominating number of "employees who are able to receive income payments"? Will it extend to include all members of the class of beneficiaries who are, at that time, employees or officers of the company, or group, concerned? Or, is it intended to be confined to those employees who are excluded from participating by receiving benefit in a capital form, but are nevertheless still able to receive benefit in the form of "income for the purposes of income tax"?

11.8 - Presumably, the numerator is intended to include all those persons mentioned in ss13(2) and 28(4), and not merely those who, not being participators themselves, are connected to a participator (as the question suggests)?

11.9 - It is worth remembering that the "close companies" case of the Disguised Remuneration legislation in Part 7A, ITEPA 2003 (s554AA et. seq.) goes a long way to protecting the Treasury by ensuring that benefit received from an EBT, even if not referable to an office or employment, is brought within the charge to income tax. This does not, however, apply if there has been no "relevant transaction entered into by a close company" (per s554AA(1)(c)) because, for example, the majority shareholding in the EBT was gifted by an individual settlor who has claimed relief under s28 IhTA.

Question 12: In addition to the reforms proposed at Chapter 7, do you have any views on ways the tax treatment of EBTs could be enhanced?

It is assumed that this question relates to the inheritance tax treatment of EBTs, and does not extend to the provisions in Chapter 11 of Part 7, ITEPA 2003 (which would benefit from a review and simplification).

It is also noted that the charge to tax under s455 CTA 2010 ("loans to participators") can create issues for close companies looking to use employee benefit trusts to support share incentive arrangements for employees. This can prevent such companies from implementing share incentive plans in they way they otherwise would do, because of the cashflow costs of the s455 charge. Further comments in relation to s455 are included above in the context of the EOT. An exemption from the charge in limited circumstances where the loan is to a section 86 trust for the purposes of acquiring shares to be appropriated to employees in connection with an employees' share scheme (as defined in the Companies Act 2006) could create greater flexibility for this type of company to offer share incentive awards to the workforce more widely.

Section 86 IhTA

12.1 - This has always been difficult to interpret and apply as it is drafted in a manner which is obviously intended to extend the scope, of what is a "gateway" provision, to both incorporated and unincorporated bodies and refers not only to employees and officers of a particular body carrying on a trade, profession or undertaking, but also to those engaged in a particular trade or profession (and who may therefore be engaged in a variety of unrelated businesses or by different and otherwise unconnected or unassociated bodies). This has allowed the establishment of settlements which (so certain KCs have asserted) are compliant with s86 but have been intended and used for what were clearly tax avoidance purposes.

12.2 – As an example, a trust drafted by a KC which was intended to qualify as an s86 trust notwithstanding that the class of beneficiaries included only persons related to or dependent upon officers of the company, and excluded those who are themselves employees or officers. This suggests that the requirement of s86(3) needs to be expressed to apply where the class of beneficiaries is defined by reference to the persons mentioned in ss(1)(b), as well as those mentioned in ss(1)(a).

12.3 - The opportunities for such tax avoidance would be restricted, or possibly removed altogether, if s86 were re-cast and re-enacted in a manner which reflects the modern purpose and legitimate usage of EBTs.

Exclusion of trusts for persons engaged in a type of trade?

12.4 - First, we suggest that consideration be given to whether the benefit of this gateway provision should be restricted to certain types of body, excluding trusts for the benefit of persons engaged more widely with any employer, or type of employer, albeit that they are all engaged in a particular type of trade or profession. While there may be some legitimate legacy settlements which were established for the benefit of persons engaged in a specific type of craft or trade or profession, in practice this seems to be a rare occurrence.

Exclusion of officers?

12.5 - Secondly, should s86 extend to trusts for the benefit of a class which includes officers who are not employees? There are sound company law and other reasons why it is typical for an EBT to have a class of beneficiaries restricted to current, former and future bona fide employees, excluding non-executive directors and other officers who are not, and have not ever been, such employees. What is the policy reason for allowing the inclusion of non-employee officers?

Split s86 into two provisions: one for trusts for employees of a body corporate, and one for employees of another specified body?

12.6 - Typically, EBTs are established for the benefit of a class of employees of a single company or of members of a group of companies (as closely defined in the trust deed) – although it is far from clear that s86(1)(a) is properly to be interpreted as allowing the class of beneficiaries to be defined by reference to employment within a group of companies. It might be helpful if, to reflect this commercial practice, s86 were to be split into two distinct provisions, one of which refers to a trust for the benefit of employees of one or more bodies corporate, with a requirement that, if the class extends to employees of two or more companies, the beneficiaries must – if the trust is to preserve its s86 qualifying status – be restricted to employees and former employees of the body corporate identified ("Company A") and any other UK resident company which, at the time of exercise by the trustees of any dispositive power, is a subsidiary (and under the control of?) of Company A.

12.7 - It might also be a requirement that the companies concerned must all be trading companies or members of a trading group.

12.8 – We understand that there has been a number of EBTs established for the benefit of employees and officers of a family-owned property investment company, the intention being to benefit only family members, without regard to the wider class of beneficiaries (if any) – as was the case in *Bhaur v Equity First Trustees*.

12.9 - If the trust is for the benefit of employees of a close company which is the holding company of a trading group of companies, the exemptions could be available only if the class of beneficiaries extends to employees (etc.) of all UK resident members of that group, thereby restricting the use of an EBT to benefit only those (the family members?) employed in a single group company.

12.10 - However, there would need to be a proviso to this in that a trust should not cease to be an s86 trust by reason only that Company A ceases to exist because, for example, following a takeover or corporate reorganisation, it has become an intermediate holding company which serves no commercial or financial purpose and is therefore wound-up, or the company ceases to be a trading company or holding company of a trading group.

12.11 - It would also be helpful if a trust were not to lose its s86 status if the class of beneficiaries were to be extended to include persons who become employees of a holding company of Company A ("Company H") after Company A becomes a subsidiary of Company H in consequence of an internal corporate reorganisation not involving a change of control of Company A, as opposed to a takeover or other change of control of Company A. (Clearly, those transferred up to Company H from Company A and its subsidiaries will count as "former employees" of Company A or a member of the group of which it was the holding company, but the idea is to allow the inclusion in the class of beneficiaries of new employees of Company H without the trust ceasing to be an s86 trust.)

12.12 - A separate section, 86A, could apply the gateway requirements to trusts for employees of other specified bodies such as unincorporated businesses and partnerships (including LPs) and LLPs.

The "all or most" requirement

12.13 - The requirement, in each of ss13, 28, 75 and 86, that the class of beneficiaries must include "*all or most*" of the employees and officers of the company concerned (and, in the case of s13, its subsidiaries) is vague and a judgement, as to whether it is met, subjective. The fact that it was thought necessary to add ss13A and 28A to take account of EOTs shows that difficulties arise if, for example, a trust excludes officers who are not employees and, in the case of a close company,

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participators and connected persons are necessarily excluded to meet the separate requirement of ss 13(2) and 28(4). Uncertainty can also arise if a number of directors or employees exclude themselves from participating as members of the class of beneficiaries.

12.14 - It would provide greater certainty if the requirement were to be expressed as a need for the class of beneficiaries to extend to include all persons who are for the time being employees and former employees, other than (i) those excluded to ensure compliance with those sub-sections, (ii) any person beneficially entitled (directly or indirectly) to, or to acquire, a specified percentage [5%?] of the issued share capital – as opposed to any class of shares - and (iii) any person who has asked to be excluded (for whatever reason).

The 5% rule

12.15 - The exception, in ss 13(3) and 28(5), to the exclusion from benefit of participators in a close company, of persons beneficially entitled to, or to rights to acquire, more than 5% ***of any class*** of shares is a trap for the unwary. If, for example, options to subscribe for shares of a specially-restricted class of “employees’ shares” are granted by a close company to a large number of employees (each option being over less than 5% of that class), but one such option is exercised early, that optionholder will become an excluded participator as the shares acquired, even if a small holding, will represent more than 5% of that class.

12.16 - Would the mischief identified be addressed by expressing the exception in terms of being 5% of the issued share capital of the company?

An anti-avoidance rule?

12.17 - The mis-use of EBT in family-owned or other close companies might be addressed by providing that all exemptions from inheritance tax (as an EBT) are forfeited if, in the case of a close company, the trustees exercise their dispositive powers (whether to apply capital or income) in favour of persons who, at that time, together (and together with those previously benefitted) represent fewer than, say [10]%, of those who at that time are employees of any company whose employees are within the class of beneficiaries; or, in the case of a company which has ceased to be a trading company or holding company of a trading group, less than that percentage of all those who were employees at the time of such cessation. For this to work, small amounts of benefit would have to be left out of account, the idea being to deny the benefit of inheritance tax exemptions if the trust fund is applied for the benefit of only a small number of those persons making up the current workforce.

Income tax: relief for distributions of dividend income

12.18 - As described in our responses to the earlier questions re EOTs, there is a case for encouraging the re-distribution of wealth amongst employees by providing, in relation to a genuine “s86/s13 or 28” trust:

- an exemption from income tax in the hands of the trustees for dividends paid on shares beneficially held by the trustee if such dividend income is paid out on an “all employee/similar terms” basis within, say, 30 days; and
- that such receipts by employees are taxed as dividend income, not employment income, in the hands of each recipient.

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CGT – levelling the playing-field

12.19 - We believe it would be helpful to the UK share trustee and administration industry, if the CGT rules were changed so as to "level the playing-field" between EBTs with offshore trustees and those with UK resident trustees. Companies wishing to establish an EBT for the purpose of warehousing shares pending their transfer or sale pursuant to an employees' share scheme are typically advised to use a non-UK resident trustee to avoid any risk of liability to capital gains tax on the part of the trustee. Does this not put UK trustee service providers at a disadvantage?

12.20 - Section 144ZA TCGA 1992 has gone some way to removing the risk of UK trustees incurring a liability to CGT when transferring shares pursuant to the exercise of an employee share option. Further, s239ZA TCGA affords relief on a disposal to a beneficiary other than pursuant to a share option, although there are conditions which must be met including that no actual consideration is given for the disposal. It follows that a sale of shares (for example) by an EBT to an employee for a consideration, otherwise than pursuant to an option, will give rise to a CGT liability on the part of the UK trustee.

12.21 - There is also uncertainty as to whether the exemption afforded by s239ZA applies if the shares transferred are subject to a short-term risk of forfeiture: whilst the employee may suffer a charge to income tax at a later time when the risk falls away or the shares are sold, there is no charge at the time of the transfer by the trustee (but see the answer to FAQ No. 18 in Tax Bulletin No. 46 which suggests otherwise).

12.22 – There do remain circumstances in which transfers by UK trustees of an EBT can give rise to a market value CGT charge when there is no such liability if the transfer were made by an offshore trustee.

Appendix 1

Prepared by David Craddock, specialist employee share schemes adviser, expert share valuer and tax consultant, and member of the Esop Centre's steering committee, for consideration as review points in response to Chapter 3 - Employee Ownership Trusts: Policy objectives and assessment of the current state of the reliefs.

Review points:

1. The absence of financial benefit for the employees

The fundamental concern with the EOT is that it does not deliver either a capital return or dividends to the employees and in effect, therefore, denies the application of the well-recognised employee share scheme principles of "identity of interest" and "wages of capital" which provide the basis the economic growth through enhanced productivity and profitability based on a strengthened sense of motivation and incentive for the employees.

2. The requirement to learn the lessons from the work of Louis Kelso

The work of Louis Kelso in connection with the introduction of the first Employee Stock Ownership Plan (ESOP) in 1956 for his client, Peninsula Newspapers based in Palo Alto California, from the which the principles of “identity of interest” and “wages of capital” emerged, derive from the economic recognition that as a rule of thumb capital values rise faster than wages. The purpose of the employee share scheme is to offer a mechanism through which that imbalance can be corrected. The EOT in its current form fails in this regard.

3. The requirement for the linkage to an all-employee share scheme

For the EOT, the capital gains tax exemption is not even conditional on the introduction of the qualifying bonuses for the employees. The introduction of the EOT should be dependent on the allocation of the shares held by the EOT to the employees on an all-employee basis with the opportunity for personal financial gain for the employees, i.e., capital gains and dividends that extend the reward benefit to employees beyond wages and encompass reward benefits from direct share ownership.

4. The requirement for the EOT ability to trade

Furthermore, the EOT should have the express ability to trade and not simply act as a warehousing mechanism for the shares. The requirement for the ability to trade enables the employees to sell their shares when they leave the company and realise capital gain. It is only through delivering financial gain to the employees that the employee share scheme can deliver the redistribution of wealth based on corporate success, thereby contributing to employee social mobility and the levelling-up agenda.

5. The impact on local employment levels

The EOT does have the advantage of preserving the independence of the company and acting as a deterrent to takeovers that lead to rationalisation and redundances as the acquiring company seeks to obtain economies of scale and recoup the cost of the takeover. In that sense the EOT assists healthy localism, maintains employment levels, and preserves the culture of the region within the business. However, that in itself does not provide the employee motivation and incentive that the empirical evidence indicates supports the profitability and growth of the business which in turn increases employment levels rather than simply maintaining them.

6. The requirement for a linkage to employee pension provision

There is a path to be taken that combines the positives of the EOT with the positives of direct employee share ownership and the merits of the US-style ESOP without the downsides. The UK has traditionally been weak in linking employee share schemes to pensions. There are lessons to learn from the US ESOP for implementation in the UK in linking employee share schemes to pensions. To enable that linkage, the EOT should be remodelled to facilitate employee development of future pension provision.

7. The reform of the qualifying bonuses

The qualifying bonuses should be a compulsory feature for a company whose shares are owned by an EOT, thereby recognising the merit of operating a long-term direct participation employee share scheme alongside the sister policy of short-term cash profit-sharing arrangements. Considered thought should be given to ensuring that both the long-term share-based returns and the short-term cash profit-sharing returns are supported by credible and effective tax reliefs for the employees. Remember also that an increase in cash profit-sharing with the opportunity to increase the percentage of pay that is variable pay in the business has the potential to stabilise employment levels by avoiding redundancies on a downturn in the trade cycle of the economy in an individual company and in the economy as a whole. This is the main thesis of the work of Martin Weitzman in his book "The Share Economy", written in 1984 and commented upon at the time by the New York Times as "the best idea since Keynes".

8. The involvement of gig-workers

The introduction of the compulsory cash profit-sharing element for the EOT should have a construction that allows the company to involve gig workers in the cash profit-sharing scheme. For the involvement of gig workers, practicality would dictate that their involvement would, unlike the employees, be on a discretionary basis. However, given the growing proportion of workers who contribute to the economy through self-employed and freelanced work in its different forms, it is important that all worker share scheme and profit-sharing arrangements adapt in time to accommodate those who have opted for this form of business.

9. The requirement to maintain the multiplicity of employees share schemes

Courtesy of the cross-party support from successive governments since the introduction of the tax-approved profit-sharing employee share scheme in 1978, the UK has a significant array of employee share scheme tools. The existing tax-advantageous EMI, CSOP, SIP and Sharesave offer share option, share purchase, and share gifting schemes while the techniques that are available through the wider employment-related securities legislation offer the opportunity for further tax-efficient share scheme structures. This multiplicity of techniques must be maintained in order to facilitate the multiplicity of solutions that employee share ownership is enabled to provide in addressing multiple business problems. It is this versatility of application that gives employee share ownership its credibility as an effective business subject.

10.The phantom employee share scheme alternative

For companies that choose for various reasons not to introduce real shares direct employee share ownership linked to the EOT, they should be required to introduce phantom shares direct employee involvement, thereby fulfilling the requirement for the EOT to be linked to some form of direct employee participation. The phantom scheme, although a form of deferred bonus scheme, is still linked in the calculation of the employee reward to the growth in the value of the company's shares, thereby preserving the proven principles of "identity of interest" and "wages of capital".

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