Encouraging Financial Participation By Employees Of A Company

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

It is generally agreed by politicians of all parties that it is a good thing "*to enable employees to share in the growth in value of the business to which they contribute by their labour*".

We have, on the statute book, provision for various long-standing tax-advantaged arrangements for employees of an independent company to be able both to acquire, and then sell, shares in their employer company on favourable terms. Specifically, and presently, income tax and CGT reliefs are afforded (within limits) to ordinary shares in the employer company acquired pursuant to a **Share Incentive Plan**, and to the grant and exercise of options to acquire employer-company shares granted to all qualifying and eligible employees as savings-linked share options, and on a selective basis as Company Share Options ("**CSOP**s") or, if the company itself qualifies, as enterprise management incentives ("**EMI share options**"). In addition, employers may be eligible for relief from corporation tax for amounts corresponding to employee share option gains and certain other amounts on which employees are charged to income tax on the acquisition of employment-related shares.

Since 2014, relief (indeed, complete exemption) from CGT has been available (if claimed) for sales by individuals and their personal trusts of shares in a trading company (or holding company of a trading group) to a special form of employees' trust (an "employee ownership trust" or "**EOT**") which thereby acquires a 51%+ controlling interest in the company within a single tax year. Provided all statutory conditions are met and there is no "disqualifying event"[1] before the end of the next tax year, the vendors escape all liability for CGT on their disposal of shares to the EOT.

This legislation affords a powerful incentive to proprietors of private companies to sell their shares to such an EOT. Indeed, so far, there have been over 1,500 companies sold to EOTs and the trend has accelerated for fear of changes or restrictions being introduced (although this government has said it will only amend, not withdraw, the relief). Typically, the EOT is funded by the company being sold making cash contributions out of distributable profits, the vendors having to remain as unsecured creditors of the EOT until future profits have been generated sufficient to put the trustees in funds to enable them to pay any outstanding consideration.

[1] Such as a reduction below 51% of the EOT's interest or a sale of the company or its business or a distribution of benefits otherwise than on an all-employee/similar terms basis.

While an EOT-owned company can pay annual tax (but not NICs)-free bonuses of up to £3,600 to qualifying employees, employee beneficiaries of the EOT cannot – unless the company or its business is sold on - individually benefit from growth in value. Even if the trustees subsequently sell-on the company, the amount received by the trustees - after a clawback charge to CGT on their part and the payment of outstanding consideration due to the original vendors - is unlikely to leave much 'in the pot' for the employee beneficiaries, and what is paid to them is taxed as employment income, not capital gain (see the example below).

The legislation is flawed, and experience suggests that in many cases the arrangements are structured with the primary objective of allowing a tax-free sale and extraction of profits, rather than with any real intention of enabling the employees to benefit from future growth in value or from the company being owned and controlled by trustees on their behalf. Nevertheless, the EOT-ownership model, which in many respects emulates the example set by The John Lewis Partnership, is held up by some as the ideal way to maintain independent private-company ownership on a sustainable basis. While it may afford an alternative to a trade sale or a disposal to private equity, it should be remembered that there is only one John Lewis…..and look at where that is now!

Crucially, The John Lewis Partnership is not – and an EOT-owned company is not – an employee-owned company. It is a company owned and controlled by a trust, and the question to be asked is: who are the trustees, and who appoints and removes them?

Further, individual employees of John Lewis/Waitrose do not own shares in the group. "Partners" so-called might (but have not recently) receive annual bonuses out of profits – taxed as employment income. What they do not enjoy is any ability to benefit financially from the growth in value to which they contribute.

In my experience – having advised upon and devised the ownership structures of multiple employee-owned companies, employees' trusts, and employee share schemes, beginning with the privatised bus companies in the early 1980s – the most successful private company ownership structures (in terms of resulting in substantial growth in value and employee satisfaction and reward) 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 shareholding investor; 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.

The case for change

There is a strong case for a change in the UK's tax (and company law) regime to allow and encourage employees, workers and others who contribute their personal services towards the business of a trading company, to be able both:

- to participate in dividends out of profits generated annually on shares held on their behalf collectively in a trust; and

- to benefit from growth in value of shares which they may acquire on and after appointment, and dispose of on or after leaving (or after a reasonable holding period).

We need a regime which encourages sustainable independent ownership of successful businesses, not one which positively incentivises individual shareholders to sell out and run away. We need a UK version of the German "Mittelstadt". Very broadly, our existing tax regime encourages the sale of successful private trading companies. It does not, as in many European countries, allow and encourage the maintenance of independence through succession of family and employee ownership.

The idea of "companies with employee ownership" (as opposed to "employee-owned companies") as being "a good thing" was recognised by the former coalition government and model documentation to support its implementation was published on the Dept for Business website in 2013 and still remains accessible. By contrast, the EOT regime was independently devised by HM Treasury (without consultation with the Dept for Business as it then was).

The policy behind the EOT 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 who should be enabled to benefit personally 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 giving little or no opportunity for employees (supposedly those persons for whose benefit the EOT regime was enacted – the clue being in the title!) to benefit, other than by limited enhancement to their taxable employment income. I give you an example to illustrate the current position:

> Rather than sell a company worth, say, £10m to a trade buyer keen to acquire it, and accept a CGT bill (assuming entitlement to BADR) of 10% on the first £1m, and 20% thereafter, Mr X can instead (i) sell, say, 75% to an EOT for say £7m (discounted to reflect the size of the holding) of which, say £2m is paid upfront, and (ii) retain 25% with a view to waiting until after the end of the next tax year. Then, the trustees (who may well be effectively controlled by the original vendor(s)) agree[2] to join in a sale to the trade buyer for, say, £10m in aggregate. If the trustees' 75% is sold for, say, £7.5m, the trust fund (after (a) tax of, say, 20% on their gain, over the, say, nil inherited base cost of Mr X, and (b) payment of the balance remaining of the consideration due to Mr. X (£4m)) is left with (£9m - £6.5m =) £2.5m to be distributed amongst the qualifying employee beneficiaries subject to PAYE income tax and NICs. Mr X will have received £7m tax-free, and £2.5m subject to CGT (of which £1m is at the reduced BADR rate of 10%).

I set out below a summary of what might be done:

(a) to improve the EOT regime in order to enable and allow individual employees to benefit from distributions of profits and capital growth, and

(b) to enable all employees, workers, consultants and individual contractors of an independent company (or member of an independent trading group of companies) to benefit likewise and in a manner which is treated for tax purposes no less favourably than that afforded to other investors.

[2] If, but only if, they are of the reasonable judgement that to do so is in the best financial interests of the employee beneficiaries.

Companies controlled by an EOT

I suggest the following changes:

1. Restrict relief from CGT for disposals of shares to an EOT to no more than the (discounted) market value of the respective holdings of shares sold by claimants.

2. Remove the provision for tax-free annual bonuses payable by EOT-owned companies and, instead, provide an exemption from income tax on the part of the trustees of an EOT for dividend payments received from the EOT-owned company if:

   (a) the dividends are paid out to eligible and qualifying employees on an "all-employee and similar terms" basis; or

   (b) the dividends are retained by the trustee(s) and applied (within, say, 3 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 (of 3 years?) 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). This need not be limited, as are the annual tax-free bonuses, as – unlike the payment of such bonuses - the ability of the EOT-owned company to pay dividends is dependent upon the generation of distributable profits.

3. Provide that such payments, made out of dividend income of the trust, to employees of an EOT-owned company (and ex-employees who have left for whatever reason within the past 12 months) are taxed as dividend income, not as earnings.

4. Amend the existing tax rules so as to provide that disposals of ordinary shares in the EOT-owned company beneficially owned by employees (as "employment-related securities") to the EOT for a consideration which does not exceed the pro rata market value described at 2(b) above is taxed as capital gain, not as employment income (see Chapter 3D, Part 7, ITEPA 2003).

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** without that being a disqualifying event (see footnote above), ***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 changes to SIPs, which have been separately suggested in a response to the Call for Evidence by HMRC 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 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).

Other more detailed and technical changes recommended to HM Treasury are set out in my response to a Call for Evidence earlier in 2023. The detailed response is to be found at: https://davidpett.tax/2023/08/20/employee-ownership-trusts/

Changes proposed to encourage financial participation by employees in other companies

The ideas put forward in items 2 and 3 above may also be applied to all other independent companies or groups of companies, not just those which are majority owned or controlled by employees or trustees. It is often asserted that it is wrong in principle to encourage employees, by participating in employee share schemes, to "put all their financial eggs in one basket" by becoming dependent upon the fortunes of their employer to secure their employment income, their pension, and their savings. By allowing, without tax disadvantages, an employer to fund an employees' trust to acquire a tranche of ordinary dividend-entitled and non-restricted, or publicly-traded shares, to be held on a collective basis for the benefit of employees, past, present and future so as to allow them to participate as suggested above and without individual risk, would be attractive to many, including private-equity backed, companies. At present, for example, a loan by a closely-held company to an employees' trust for such a purpose attracts a penal tax charge under the "loans to participators" rules. Finally, many larger companies, both publicly traded and privately-owned, ***do*** have employees' trusts which they use to warehouse shares pending their transfer to participants in share-based incentive arrangements (such as L-TIPs, Restricted Share Plans. JSOPs, Growth Share Plans, etc.). It has been repeatedly pointed out to HMRC and Treasury Ministers that the reason why companies typically appoint ***offshore*** (typically in the Channel Islands or Switzerland) independent trustee services companies, not UK trustees, as corporate trustee of their employees' share trust, is that existing tax rules treat them more favourably than UK-resident trustees. Why the government has not at least "levelled the playing field" and allowed companies to repatriate their employees' trusts without penalty or risk of CGT charges on gains in the trust, is a mystery.

The government is expected to make changes to the EOT regime in the 2024 Finance Bill. It remains to be seen if the wider changes sought will attract support from a new government in 2024.

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