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Transcript of Employee Ownership Trusts webinar

Stephen Woodhouse leads a webinar discussion on Employee Ownership Trusts with fellow partner at Pett Franklin, David Pett.

Under discussion is the new legislation on Employee Ownership Trusts, its background, features, requirements and the potential benefits and pitfalls.

Stephen: **Welcome to this morning session on Employee Ownership Trusts. I'm very pleased to be with my partner David Pett who's been integral in developing and designing many of the ideas in this area. It's an important subject as is shown by the number of inquiries and the amount of focus on the topic that we certainly experience professionally. So hopefully over the next 40 to 45 minutes we'll answer some of your questions. I just wanted to start this morning by looking at the background to the employee ownership trusts legislation. I'll just ask David to talk about what all that background is.**

David: The current coalition government has made great play of encouraging the development of employee owned companies led of course by John Lewis partnership which is by far the most high profile as well as the largest in terms of numbers of employees. This has generally been conceived politically as being a good thing to encourage companies to consider conversion to employee ownership through a trust as a third way, an alternative to a trade sale of the company or perhaps to, in certain cases, an alternative to flotation of the company.

Part of that initiative in 2013 was taken forward by the Department for BIS in producing a pack of model documentation for a company seeking to encourage employee ownership. Once that project was completed, and you'll see on the Department of BIS website a pack of such model documentation, the treasury then took a rather different tack by publishing legislation which afforded new tax reliefs for a particular type of employees trust, very generous tax reliefs in the view of many, but using a wholly new type of employees trust.

The terminology is sometimes confusing. So far as the policy-makers are concerned there is a difference between a "company with employee

ownership" and an "employee-owned company". The former may well be one which is owned and controlled by private shareholders, the founders perhaps, but whose employees, or a substantial number of employees, hold direct ownership of shares in that company.

By contrast the term "an employee-owned company" has come to be ascribed to a company which is principally owned by an employees' trust. Employees themselves do not necessarily have direct ownership of shares in the company but trustees will hold a block of shares typically a controlling interest in the company on trust for the benefit of all employees.

Stephen: **Can you explain to me what the difference is between the new style employee ownership trust and a conventional employees' trust, employees' share trust?**

David: Conventionally an employees' trust has been established as a discretionary settlement for the benefit of a class of beneficiaries defined as all employees past, present and future of the company, or if it's a member of a group of companies, all past, present and future employees of all those members of that group of companies. The trust deed has provided for very wide discretionary powers on the part of the trustees as to how the trust property, typically shares in the company or cash, may be paid or applied for the benefit of any one or more of the members of that class of beneficiaries. That allows tremendous flexibility to use the trust as a vehicle for holding shares pending their distribution or award or a grant of options over them to specific employees or possibly through the operation of a share-incentive plan or an SAYE share option scheme for the benefit of employees generally.

By contrast the new style employee ownership trusts is far more restrictive. It's a requirement of the legislation that the dispositive powers of the trustees must be very narrowly drawn so that benefit can only be applied on the basis that it is for the benefit of all existing employees and on an equal terms basis. There are some minor exceptions to that but the general rule is that the dispositive powers must not allow the trustees for example to make loans, to create sub trusts or to transfer property to any other settlement unless it is itself an employee ownership trust. If ever they do choose to apply benefit at all then that benefit must be applied on an all employee basis on equal terms.

Stephen: **Cn we turn to why would one want to establish an Employee Ownership Trust?**

David: The carrot for looking at using an Employee Ownership Trust is really the provision of the two new tax reliefs. The one is an exemption from capital

gains tax on a disposal of shares in a trading company or holding company of a trading group to an employee ownership trust provided that within a single tax year the EOT, as I'll call it, acquires a 51% controlling interest. It has to have not had a controlling interest at the start of the year but to have acquired that controlling interest by the end of that tax year.

That's an extraordinarily generous relief on behalf of vendors, proprietors particularly of small companies if you've got a husband and wife-owned trading company. For example a husband and wife might wish to retire then in practice they may sell the company to a trade purchaser perhaps. This affords a more generous tax treatment if the company is instead sold into the ongoing ownership of an employee ownership trust. Of course when we refer to the trust what we really mean is the trustees of that trust. Typically the trustee will be a specially incorporated company, perhaps a guarantee company or a company with share capital, which will act as the sole corporate trustee of the trust. Very often that trustee company is itself formed as a directly wholly owned subsidiary of the trading company, so you have a circularity of ownership.

There's no reason why the trustees could not be individuals and indeed there's no restriction in the legislation itself as to the vendors remaining as trustees of the trust. There's a potential risk of unlimited personal liability on the part of individual trustees and that's usually one of the reasons why we have a corporate trustee. Bearing in mind that there may be circumstances in which it's appropriate to apply for a section 701 clearance under the “transactions in securities” rules, typically if the vendors are disposing of less than 75% of their interest in the company, then in those circumstances our experience is that the Revenue would insist upon a degree of independence on the part of the trustees which implies that although the vendors might remain on the board of the trustee company, that board should be constituted in such a way that there are independent trustees who hold the ring as between the vendors and any other management individuals who are on that board.

That's the first carrot. The second carrot is a new relief from income tax. A company which is owned by an EOT may now pay tax-free bonuses but only on an all-employee, equal terms basis. Such that the first £3,600 per employee per tax year is free of income tax, not, it should be noticed, free of National Insurance contributions, but only of income tax. So far in our experience there had been quite a number of companies who have looked to transform themselves into companies owned by EOTs, not necessarily to secure the CGT relief for vendors, but rather to gain access to the ability to pay tax-free bonuses on a company-wide basis.

Stephen: **The CGT relief is still going to be of substantial benefit in the right circumstance. Could you just outline the principal requirements for obtaining that relief?**

David: There are 5 principal requirements. First of all the trading requirement. The company itself must be a trading company or a principal company of a trading group of companies. Secondly there is what's called the all-employee benefit requirement. This loops back to the point I made earlier that the trust deed itself must be restrictively drawn so that the dispositive powers of the trustees can only be exercised in a manner which benefits all employees on an equal terms basis and restricts the manner in which the trustees can otherwise apply the trust fund. You remember there must be no ability to make loans, there must be no ability to transfer a property into sub-trusts for particular employees.

Thirdly there's the controlling interest requirement which in essence is that the trust must within a single tax year have acquired greater than 50% interest in the company. That's 50%, more than 50% of the votes, more than 50% interest in the surplus assets on a winding up and more than half the entitlement to dividends in the company. It must end up by the end of the tax year with the company being under the effective control of the EOT.

There's also what's referred to as the limited participation requirement. This is intended to weed out those very small companies where the number of employees in the company relative to the number of vendor shareholders is very small. It's quite a complex test that has to be applied. We'll come back to look at that in a little more detail later.

Fifthly there must not be a disqualifying event in the next tax year. If there is then any claim for relief from CGT on the part of the vendors is nullified. What mustn't be forgotten is that the relief must be positively claimed.

Stephen: **Could you expand a little bit on the 50 per cent requirement?**

David: It may well be that there a number of individual shareholders of the company. I remember that when the legislation was first at the discussion stage it was originally proposed I think that relief would only be available on a single disposal of a controlling interest. But that's not how the legislation has shaped up. Multiple vendors can claim the relief in respect of disposals into the trust but the key point is that all of those disposals must be made within the same tax year. Whereas the starting point is the trust must not have a controlling interest, by the time you get to the end of that tax year, it must have acquired that 51% controlling interest. There certainly can be multiple vendors and each can claim the relief.

It's individuals who are entitled to the relief and trustees. A corporate vendor is counted out but where a trustee is a corporate trustee then it's understood the Revenue accept that the relief will be available to that vendor. The relief can't be claimed for successive disposals by an individual in successive years. In short there's only one opportunity for a bite of the cherry.

Stephen: **I think the other question that jumps out to me is the meaning of the all-employee benefit requirement. Who must be excluded? Who may be excluded?**

David: Well, in short, all employees of the company, or if it is a member of a group of companies and it needs to be the principal member of the group of companies, then all employees of all members of that group must be included. There are detailed rules which do allow the exclusion of those employees who have not held a minimum qualifying period of employment.

There is also an opportunity expressly allowed for in the legislation to invite employees to express a wish as to whether they might want to be excluded from participation. Certainly in my experience we've had a number of individuals over the years who, principally for religious reasons, have asked not to participate in an all-employee scheme. So there is a facility for that in this case. It's also necessary to exclude participators in the company, at least those who previously were participators or continue as participators – by participators I mean in essence those who are shareholders or loan creditors of the company.

Participators and their connected persons, basically relatives of the participators, must be excluded unless their interest is and always has been less than 5 per cent of any class of shares. Note here the subtlety. It's less than 5 per cent of any class of shares, not less than 5 per cent of the share capital of the company.

Also one point I should add is that we're not here looking exclusively at closely-controlled companies. The rules which require the exclusion of participators also extend to those who are participators in non-close companies.

Stephen: **Are there any unusual features to the relief which we as advisors or as companies ought to be aware of?**

David: Provided there is no disqualifying event such as, for example, the trust ceasing to hold a controlling interest in the company before the end of the next tax year, then the vendors can walk away with the benefit of the tax exception and no further risk of claw back. So if you're a husband and wife of

a successful trading company and you sell out to an employee ownership trust you can, following the end of the next tax year, walk away with confidence knowing that you need not make any further provision for any claw back of the tax relief that you've enjoyed.

If in future years there is a disqualifying event, and that might typically be the trustees selling on the company or perhaps the trustees acting in breach of the trust deed or in breach of the rules required to satisfy the all employee-benefit requirement and the equal terms requirement, then there will be a claw back of the relief that was first given. Given that the trustees will inherit the base cost for CGT purposes of the vendors, that could be quite a significant charge but the charge falls on the trustees not the original vendors.

One of the things that the trustees who acquire the controlling interest in the company must be very mindful of at the time they do it acquire that is the need to protect against any disqualifying event or at least ensure that adequate provision is made for that eventuality.

Curiously, and this was a point we pointed out to the lawmakers when the legislation was first published, there's no restriction on using an offshore trust, in other words a trustee which is controlled and managed outside the UK and is resident outside the UK.

Now the Revenue have maintained a long standing policy of accepting that where a trust is used for normal commercial purposes as part of employee share incentives then they accept that an offshore employees' trust is outside the scope of UK capital gains tax and outside the scope of the anti-avoidance provisions for offshore trusts. There is the possibility here, and sadly we're aware that some advisors have already picked up on this and have been promoting the use of an EOT on this basis, for an offshore trustee having acquired control and satisfied all the requirements for the relief on the part of the vendors, will then wait, sell the shares in circumstances where there is a disqualifying event and a claw back charge, but arguably it's not open to the Revenue to recover that from the offshore trustees. That's certainly not how we have been using or establishing the trust and it would be a shame if that was an arrangement adopted which undermines the benefits of these reliefs.

Stephen: **One particular point that has come up is the way you have a trust which controls the company and the trustee is itself a company. This would normally mean that the company could not qualify to grant options or award shares under a tax advantaged scheme such as EMI, CSOP, SAYE etc. Are there any special rules to govern this in the context of an EOT?**

David: Yes. This was a point picked up by the policy makers very early that of course by definition the company would be under the control of the trust and where typically it's a corporate trustee would be under the control of another body corporate and so fail the independence requirement for establishing and operating a tax advantaged EMI, CSOP or SAYE scheme or a Share Incentive Plan. Special provision has been made and as from 14th October there is one exception to that rule. In the case of a company which is owned and controlled as to more than 51 per cent by an Employee Ownership Trust the independence test will be deemed to be satisfied for those purposes so that such a company can still operate such a tax advantaged scheme.

Beware, however, it should not be on the basis that options are granted or satisfied by the trustee - at least not in so far as that might cause the trustees holding to fall below the 51 per cent controlling threshold because of course that would trigger a disqualifying event. Typically a small company might grant EMI options to subscribe for new shares but care must be taken to ensure that the exercise of those options would not result in dilution such that the trustee's interest falls below 51 per cent. It might therefore be appropriate to operate a second trust alongside an EOT, a more conventional discretionary employees' share trust. The shares held by that trust could then be the subject of such tax advantaged schemes.

Stephen: We're moving on to looking a bit detail about the arrangements for tax-free bonuses. What do companies need to do in order to be able to qualify to pay such bonuses?

David: The rules are broadly similar but in their detail can differ from those that apply to eligibility for the CGT relief. The company must be a trading company or a principal member of a trading group. There is the indirect ownership requirement, in other words the company must be 51 per cent owned by the employees' trust. You remember that there was a limited participation requirement I referred to earlier which is intended to weed out those companies with a relatively small number of employees relative to those who could qualify for the CGT relief. Well, there's a similar test but it relates to the ratio of employees in the company to the number of office holders in the company.

Also the arrangements must not be used in the manner of a salary sacrifice. The lessons of profit-related pay have been learned here and it's quite clear that the bonuses must be over and above any existing entitlements and there must be no element of salary sacrifice involved in the arrangements.

Stephen: **Just looking at the way the relief is set up, do you think it's been sensible for the relief to be structured as tax-free bonuses paid through payroll?**

David: Well, I understand, that when treasury inquired of a number of companies what they thought would be the easiest way of structuring this relief, the answer came back, well, just offer the relief through the payroll. The way it's been structured is that the bonuses are paid through the payroll but there's a special exception in ITEPA for such bonuses in so far as they qualify and do not exceed the £3,600 limit.

Logically I, and I know a number of other advisors, think that it would have been better had the Treasury decided to allow an employees' trust of any description which holds shares in a company to receive dividends on those shares and, provided those dividends were paid out to all employees on an equal terms basis within a limited time period, they should be exempt from tax in the hands of the trustees and treated as dividend income in the hands of the employees.

That would actually have been self-policing because clearly only if and in so far as the trust actually holds shares and receives an amount of dividend on those shares would it be in a position to pass those out to employees in this tax advantaged manner. I suspect there wouldn't be much of a loss to the treasury and it would be a logical way of structuring it.

As it is we've ended up with this arrangement where the tax-free bonuses are paid by the company which means that payment is under control of the directors of the company, not under the control of the trustees of the trust which owns the company, and that can set up an interesting dynamic in the relationship between the controlling trustees and those to whom responsibility for management and conduct of the business of the company has been delegated, namely the directors of the company.

Stephen: **Many companies will have an existing employee trust. Is there scope for such a trust to be used as a vehicle for securing the CGT relief we've been talking about?**

David: Yes. Special provision has been made to allow certain existing trusts still to qualify, provided of course that they do within a tax year acquire a 51 per cent holding in the company and did not have such a holding at the start of the tax year, but the trust must have existed before the 10 December 2013 when the legislation was first published. It must have been at all times a section 86 trust, broadly speaking a trust for the benefit of employees which satisfies the requirements in section 86 of the Inheritance Tax Act. It must

have held a significant interest in the company on 10 December. For these purposes that is at least a 10 per cent interest in the company.

Then there's what's called the behavioral test. In other words the trust must not within the past 12 months have applied the trust property otherwise then for the benefit of all eligible employees on same terms, must not have created sub-trusts or transferred properties to other trusts or made any loans. In other words if it has behaved in a manner which is consistent with the new legislation then it is deemed to satisfy the all-employee benefit requirement. Those trusts that have done nothing, have simply sat on the shares, may well qualify under this head without the need to set up a new trust as an EOT and transfer property to the new trust.

Care must be taken in this regard. For example, suppose within the past 12 months a general discretionary employees' trust has transferred shares to a share-incentive plan for awards to be made on an all-employee equal terms basis. One might think that in those circumstances the trust would satisfy this behavioral test but looking at the small print one finds that that will not be the case. Even where you think you satisfied the requirements, you may well not have done. That does require some careful analysis.

Stephen: Can a company which already has a 51 per cent plus employee owned company qualify to pay tax free bonuses?

David: Yes. We've seen a couple of companies already which are in a position of being employee owned through indirect ownership through a trust. Yes, they can qualify if the trust existed before 10 of December 2013. Again, it's a Section 86 trust, it holds a 51 per cent interest, and again, provided the behavioral test is satisfied so that it has not within a period of 12 months before the bonus payment is decided upon applied the trust property otherwise than on an all-employee equal terms basis.

Stephen: It would be helpful I think to talk through how a typical structure might work in terms of funding the acquisition of the shares and tying that with all of these reliefs.

David: I think this is quite a difficult area. I mean, the most straightforward way I suppose would be for the trustees of a newly created employee ownership trust to go to the bank and secure a loan, perhaps secured upon the shares which it is to acquire with the benefit of that loan. The loan might then be repaid out of contributions made by the company over time out of profit, but in the current climate I rather suspect there are few banks out there who are going to be willing to enter into such an arrangement on a basis that's affordable by the company. An alternative would be for the company itself to

take a bank loan, perhaps secured on the assets of the company. The company could then make a contribution to the trust sufficient to enable it to purchase the shares from the vendor. Of course much turns on the value that the vendors expect to receive for their shares and the amount of headroom the company has to extend its borrowings from the bank.

If, as is typically the case, we're dealing with a close company then a contribution by the company to the trust would normally attract a charge to inheritance tax on the part of participators in the close company unless the conditions of section 13 and section 87 of the Inheritance Tax Act are satisfied. Now in the case of section 13 one of those conditions is that the trust must be for the benefit of all or most of the employees of the group.

Now just looping back to a point I made earlier at the ability to be able to exclude from participation or as beneficiaries in the trust, certain individuals who have not had a qualifying period of employment, there was concern that EOTs in particular might not always satisfy the very specific requirements of section 13. And so there is a new relief, section 13A of the Inheritance Tax Act, which does specifically provide relief from any inheritance tax charges that might otherwise arise where a closely held company makes a contribution to an EOT to enable it to purchase the shares.

One difficultly is that relief under section 13A will apply only in the actual year in which the shares were first acquired from the vendors. Now the vendors of course might expect to receive for their shares particularly if it's a controlling interest in the company a price which is far beyond the capacity of the company to satisfy either through immediate cash contributions to the trust or by way of bank funding. The idea may well be that the vendors accept that having sold the shares to the trust the consideration which is ascertained and fixed will be satisfied by way of contributions made out of future profits generated by the company. First of all the company has to commit to applying future profits in making contributions to the trust.

So far as the vendors are concerned, they would normally expect to take security by way of a charge over the shares which they've sold to the trust but the legislation does provide that if, as any part of that security, there are any arrangements in place whereby the vendors could take back control of the company then that will not satisfy the requirements for the relief in the first place. In effect any security could only be by way of charge over the assets of the company and not over the shares.

Now there are other difficulties. In future years the company might trade successfully and generate profits which are available to be contributed to the

trust but if at that stage the trust wholly owns the company and is the sole shareholder in the company, it seems to me there's a risk that on the face of it a contribution to a 100 per cent shareholder in the company might fall to be taxed as a dividend. I know this is point that the Revenue are currently considering. Furthermore if the trust didn't satisfy the requirements of section 13 in the year when it was first established, it may well not satisfy those requirements in later years so as to protect against any charge to inheritance tax on a contribution by a close company to the trust. The new section 13A is of no help here because that only applies in the first year and not in successive years.

In the context of EBT settlements we are aware that another part of the Revenue has appeared to accept that a contribution in cash by a close company to the trust will avoid a charge to inheritance tax on the basis that it qualifies for business property relief. Looking at the small print it's quite hard to see how that analysis fits. Again, this is something we've gone back to seek clarification from the Revenue about.

Stephen: **Building on from the structuring of the trust itself, how would you expect a sale to the trust to be structured?**

David: The first point to note is that the sale must be a capital gains tax disposal. You need a disposal for an ascertained amount of consideration. The disposal has to be in the tax year. You can't have an arrangement where there's a series of part disposal spread over more than one tax year. It may well be that the vendors have to take a punt on the question of security and simply rely up on the company to fund the trust to enable it to pay installments of that consideration in future years.

I'm aware of one arrangement where there was a loan facility put in place as between the company and the trust so that the trust could unilaterally call upon the company to advance monies pursuant to that facility in order to pay future installments of the trust. It did seem to me that that didn't offer any particular commercial or tax advantage in these circumstances. It may well be that the vendors as a quid pro quo for the very generous tax exemption that they enjoy must have to accept the commercial risks associated with the sale in circumstances where the company simply cannot afford to fund the trust up front in full.

Stephen: **Once we've got the structure set up, we've got the company owned, are there any particular governance issues which an employee owned company should be thinking about?**

David: Well, this is an interesting area because of course, once the company is under the control of the trust, one then has to think about how it's going to be governed and the balance of power between the directors of the company and the trustees or trustee directors of the trust company. In drafting the articles of association of the company one has to be mindful of the rules governing, for example the appointment and removal of directors of the company.

Likewise in drafting the articles of the trustee company, who is it who is to have the power to appoint and remove directors of the trustee company? Is it necessary to ensure that there are provisions whereby the trustee will, as a term of the trust deed, always be a directly wholly owned subsidiary of the company so as to preserve for all time that circularity of ownership which I referred to before? Who are to be the trustees or the trustee directors? Are they to include employee representatives? How are they to be selected and appointed? What is the process for that? Should that be enshrined in documentation from the outset? Should there be not only employee trustee directors of the trust but possibly also employee directors of the company?

The idea of employee directors was very fashionable particularly in the 1980s but one has to remember that employee directors act as a one-way valve. They are free to communicate information to the board but not nearly so free to communicate matters discussed at the board back to all employees because of their duty of maintaining information in a confidential manner.

Stephen: Documentation is going to be an important aspect of setting up these arrangements. Do you have any comments on that area?

David: The drafting of the trust deed is key and it is not straightforward to ensure that the trustee complies in all respects with the legislation. It's unfortunate perhaps that the model documentation that has been published on the Department for Business Innovation and Skills website for companies with employee ownership is not suitable for use where it's intended the trust qualify as a an employee ownership trust. So far there is no published precedent either by the Revenue or by the Department of BIS for an employee ownership trust.

We've done a lot of work, as you no doubt expect, in developing a precedent which has been used by quite a number of other firms of advisers for such a trust. There will be a precedent published in volume 2 of our book on Employee Share Schemes next year. That will accompany a new chapter on Employee Ownership Trusts which should be released within the next few weeks. In the meantime if as advisers you do need help and assistance with

that, we would be happy to provide documentation in these circumstances which is intended to qualify as an Employee Ownership Trust.

Stephen: **Thinking about some of the wider legal or tax issues, do you see any legal or tax problems in having the company fund the consideration out of future profits?**

David: I've already alluded to some of the tax issues that arise in that respect. Is a contribution probably to be treated as dividend or as a distribution payable by the company to the trust particularly if the trust is the sole shareholder in the company? We've got the problem that the new section 13A does not extend to offer relief in future tax years. I think there's a wider company law point as to whether it is an appropriate exercise of directors' powers to commit future profits as yet unearned in the payment of contributions to the trust to fund the vendors. It does raise the specter of whether directors are acting in breach of their duties and perhaps acting in the best interest of the vendor shareholders rather than the best interest of the company and its shareholders going forward.

This is an issue which we have discussed with leading company counsel and there doesn't yet seem to be an established view on the point. I suppose in some ways it comes down a debate on valuation. Clearly the trustees must not pay more than the market value for the shares they acquire. Now if they're acquiring in one go a controlling interest in the company that may be a value that's derived on a pro rata basis. If they are acquiring a controlling interest by way of purchases of very small shareholdings from a number of disparate individual vendors then the price paid made in each case need to reflect the minority interest basis of valuation.

I think there's a question mark here for the directors of the company itself as opposed to the directors of the trustees and the vendors as to the extent which it is right and proper to enter into this arrangement on terms which vendors might well be proposing. Is it necessary for example for the company to take warranties and indemnities from the vendor proprietors? Should there be any contractual arrangement for claw back from the vendors if for example there is a disqualifying event outside the control of either the company or the trustees going forward? There are quite a number of issues to be thought through there.

Stephen: **Another area where we spent some time looking at potential issues is in relation to accounting. What accounting issues and challenges you see?**

David: If a substantial number of shares are acquired by the trust for a meaningful value in one go in order to obtain the CGT relief, then the trust is likely to be

indebted either to an external lender, to the bank or to the vendor. Now if one follows the UITF 38 or similar accounting rules in international standards then one is required to include the trust on the company's balance sheet at least at the consolidated level. If the borrowings of the trust are large relative to the company's net assets this can effectively destroy the balance sheet. The balance sheet can look very poor and superficially the company might even appear bust.

The consequences of that can be quite serious because the company will be unable to pay dividends or banking covenants might be broken or at risk and credit rating agencies might well downgrade the company. This is a complex area and with the accounting rules changing from 1st of January with the advent of FRS 102, the accounting rules will need very careful consideration in the context of any transition to an employee owned company.

Stephen: **Do you see any special factors affecting share valuations in employee owned private companies?**

David: I've already alluded to the difference between pro rata valuation and minority interest basis evaluation where different sizes of holdings are being acquired by the trust. Of course this can lead to conflicts of interests all over the show. As a starting point the trustees must be comfortable that the trust is not paying out more than the market value of the shares it's acquiring from a particular vendor. If only because in doing so it would breach the requirements of the relief in the first place because the trust would not be acting in accordance with the very restrictive provisions relating to the exercise of its dispositive powers.

If the company is going to operate a tax advantaged scheme alongside the EOT that it may well be that there are, going forward, disparities in values because of course the values agreed for relatively small parcels of shares for the purposes of granting EMI options, for example, may be on a heavily discounted minority interest basis. This is very different from the value which may be justifiably paid out to vendors of a much greater tranche of shares.

Another factor to keep in mind is the potential impact on the basis of valuation and the information standard so-called. For a tax valuation one is required to make assumptions about the information that would be available or not available to a potential purchaser of the shares. This can have a material impact on the valuation. In many companies information is confidential and therefore excluded for tax valuation purchases but with employee owned companies the level of information disclosure to employees

generally is much higher. This could affect how much information needs to be used in any valuation sought with the Revenue.

I should have alluded to earlier the fact that surprisingly the legislation does allow for the vendors, if they retain shares, to retain all rights to dividends. Put another way, it is no breach of the requirements if, under the terms of the trust deed, the trustees waive their rights or entitlements to dividends on the shares. One can end up in a situation in which vendors have sold a controlling interest, retained a minority interest but retained the rights to in effect 100 per cent of the dividends paid by the company.

Does this have an impact on the valuation? Well I think in my view, probably not because the treatment of the dividends on the shares and the fact that dividends are to be waived as a term of the trust deed doesn't actually have an impact on market value of the share themselves.

Stephen: **What challenges do you see a sale to an Employee Ownership Trust present when considered in a commercial context and as a commercial transaction?**

David: This is a difficult one. The questions of valuation, first and foremost, what do the vendors expect to receive as consideration for the sale of their shares? How is that to be funded? A bank loan, out of future profits? Is it appropriate for the company in question to transfer into the employee ownership ethos - is that going to benefit the trade of the company or is that going to put it at a disadvantage relative to its competitors? Much of this loops back to the way in which the corporate governance of the company is to be structured. I think careful thought has to be given to that.

We know of a number of situations where all other things being equal the vendors perhaps for emotional and not necessarily wholly hard-nosed commercially logical reasons would much prefer to allow the company to remain independent in the sense of being owned by an employees' trust rather than being sold as part of a trade sale. That's particularly the case it seems with certain professional practices, architects' practices in particular seem to be ripe for transformation into an employee ownership structure of this kind.

Stephen: **Given all of these advantages and equally some of the complexity, what sort of take-up do you expect to see from Employee Ownership Trust?**

David: Slowly but steady. As I said earlier the interest that we have experienced so far has been more from those companies seeking to access the ability to pay company-wide tax-free bonuses. Typically in companies which have relatively

large numbers of employees and see this as an extremely attractive way of retaining and incentivizing and attracting staff in a difficult market.

So far as vendors are concerned, whilst there is initial enthusiasm for securing the very generous tax reliefs for vendors, I think care has to be taken for all the reasons we've recited earlier. In terms of numbers of EOTs which have so far completed sales of shares or acquisition of shares from vendors, my understanding is that there are probably not more than a dozen so far.

Stephen: **Thank you David. I'm just going to check whether we've had any questions come in. I suspect we've probably covered the questions fairly extensively but we do have one or two.**

David: We've been asked re the payment of tax-free bonuses, if an EOT agreed to provide shares on the exercise of EMI options, would this be a disqualifying event from the date the options were granted or only when the options were exercised?

I think the key point here is that the trust must at all times retain its 51 per cent controlling interest. Whereas the trust could use shares held in the EOT to satisfy EMI options then care must be taken to ensure that at no time would that threshold fail to be met. I think in terms of when will the disqualifying event occur, arrangements would be in place for that test to be failed. I think off the top of my head that would be from the time when the options are granted. In those cases it might be better to perhaps ring fence those shares by having them held in another trust.

I see there's a follow-up to that. Would your answer be different if the trust was a pre-existing trust and not an employee ownership trust? No. I think the analysis is the same, the key point is that you must not fall below the 51 per cent. In the case of an existing trust which does not otherwise qualify as an EOT and therefore you're relying on the behavioral test then if the trustee had within the past 12 months granted EMI options then that would breach the behavioral requirements because it had not applied the trust property on an equal terms basis for the benefit of all eligible employees. So yes, in that sense the answer is different.

A third question, is the value at which shares are sold to the EBT checked in any way? Is it fair value or tax market value? There's no formal process for agreeing the value of these shares in advance of the transaction. Therefore there is an element of risk here. I suppose reliance is placed on the fact that there is a commercial negotiation, perhaps not an arm's-length negotiation, between the trustees and the vendors, or at least there should be because

the trustees should be acting independently of the vendors in determining the commercial terms of the sale.

The key rule is that the trust must not pay more than market value for the shares because if it does so it would be in effect exercising a dispositive power rather than an investment power and benefiting the vendors who would normally be excluded as being participators in the company.

So no, I think there are no special provisions made for valuation agreements. It's early days. It might be worth contacting HMRC Shares Valuation and seeing if they would be prepared to reach agreement upfront but I suspect given the pressures they're under at the moment, they're more than likely to decline that and leave it to the advisors and the parties to determine for themselves what is the proper market value of those shares. As I said earlier remember that if a husband and wife each own say 26%, or are each selling say 26%, then the price that they would each expect to receive for a 26% interest might well be less than the price that they might together expect to receive if they jointly owned a 52% interest in the shares.

We've been asked "Did you say earlier that the trust's base cost will carry over from the vendors, so on a future sale of the company the tax free gain on sale of an EOC effectively becomes taxable in the EOT?" Yes, correct.

Stephen: **All that remains is for me to thank David. We've got another webinar scheduled for the 15th of January on the topic of EBTs post settlement regime. We know that the Revenue are withdrawing their EBT settlement offer from 31st of March. We will be looking forward and thinking about what will happen after that date.**

If you have any interest in that please do register by emailing Shanel. Her email address is shanel.nelson@pettfranklin.com. I hope you'll be joining us on the 15th of January.

[Ends]

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