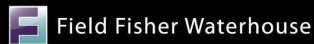




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How to get tax efficiencies from
your employee ownership
structure



18 November 2010

Introduction

Three basic employee ownership structures:

- 100% employee trust owned
- Owned directly by employees
- A combination of the two

These produce a variety of tax issues:

- Tax pitfalls when creating a new employee ownership structure
- Taxation of employee bonuses
- Awarding shares to employees
- Operating an internal market
- Financing employee ownership
- Dealing with HM Revenue & Customs ("HMRC")



How to get tax efficiencies from your employee
ownership structure

Creating employee ownership: example 1

“The Useful Simple Trust was established in 2008 ... You may be surprised to learn that the companies were either given to Useful Simple by their original shareholders or started as entrepreneurial ventures by the Trust itself”

www.usefulsimple.co.uk



Creating employee ownership: tax pitfall 1

A possible tax pitfall

Giving away shares or other assets or selling such assets at an undervalue can create a tax liability on the donor

The solution

There are helpful tax reliefs available but care is needed to get the benefit of these reliefs

An observation

Some founders are prepared to pay tax rather than restrict what the eventual employee ownership structure looks like

Creating employee ownership: example 2

“... in March 2008 the Parfett family sold just over half their shareholding to the Parfett Employee Ownership Trust. This Trust holds the shares on behalf of the employees. This means that employees do not hold any shares directly; the Trust holds the shares on the employees' behalf.”



www.parfetts.co.uk

Creating employee ownership: tax pitfall 2

A possible tax pitfall

A founder selling shares to an employee benefit trust (“EBT”) cannot be certain of getting a capital gains tax (“CGT”) treatment

One solution

Seek advance clearance from HMRC that the sale proceeds will not be treated as a disguised dividend

Another solution

Seek advance clearance for a purchase of own shares as a capital transaction as part of the arrangement?

Creating employee ownership: example 3

“Central Surrey Health Limited (CSH) is the first of a new kind of not-for-profit organisation that provides community nursing and therapy services to the people of central Surrey.

CSH is co-owned and run by the nursing and therapy teams it employs. They combine the values and principles of the NHS with the 'can do' culture of a successfully run business”

www.centralsurreyhealth.nhs.uk



Creating employee ownership: tax pitfall 3

A possible tax pitfall

Giving shares to an employee or selling them to an employee at an undervalue will create a tax liability on the employee

One solution

Create a class of share that has an affordable (perhaps negligible) value and so can be bought at market value by employees

Another solution

Employees do not pay tax on shares held on discretionary trusts in an EBT

Creating employee ownership: tax pitfall 4

An inheritance tax (“IHT”) problem

Trusts are usually subject to an IHT every 10 years

The solution

Establish your EBT as a section 86 Inheritance Tax Act 1984 employee trust

Employee trusts and bonuses

Partnership bonuses

Employee trust owned businesses have no external shareholders and so can pay John Lewis Partnership style “partnership bonuses” to employees out of profits

The tax concern

Although such a bonus is, in effect, a reward for being an employee owner it is subject to PAYE as if it were a normal reward of employment

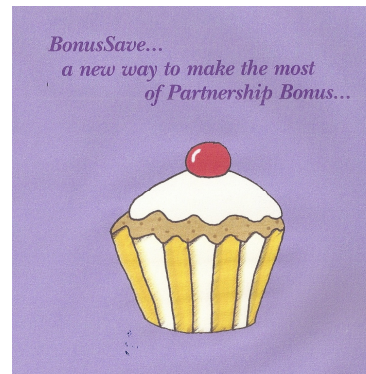
One solution

An employee trust owned company may be able to introduce a tax efficient HMRC approved share incentive plan (“SIP”) without compromising its ownership structure

Employee trusts and bonuses, continued

“The John Lewis Partnership ... gained approval to set up a Share Incentive Plan as a tax efficient vehicle for partners to save part of these bonuses ... However, this does not give savers any voting rights over and above the democratic rights they have as partners. Ownership of the Company remains entirely in the Trust.”

www.employeeownership.co.uk



Employee trusts and bonuses, continued

A problematic solution

“Spotlight 5: Using trusts and similar entities to reward employees

- HMRC are aware that companies have been seeking to reward employees without operating PAYE (Pay As You Earn)/NICs (National Insurance contributions) by making payments through trusts and other intermediaries that favour the employees or their families. The arrangements usually seek to secure a Corporation Tax deduction, as if the amounts were earnings at the time they are allocated, and also defer PAYE/NICs or avoid them altogether. **HMRC's view is that at the time the funds are allocated to the employee or his/her beneficiaries, those funds become earnings on which PAYE and NICs are due and should be accounted for by the employer.**
- **In addition HMRC's view is that an Inheritance Tax charge may arise on the participators of a close company.** Unless the participators are excluded beneficiaries and have not had funds applied for their benefit, such as the receipt of a loan, a charge to Inheritance Tax arises on participators of close companies at the time the funds are paid to the trustee by the close company. Relief is only available to the extent that a deduction is allowable to the company for the year in which the contribution is made.”

Share option awards to employees

There is no tax on awarding an employee share option but ...

The problem with unapproved share options

Unless an option is tax advantaged, the gain on exercise will be subject to income tax (and probably NICs and PAYE)

The solution

Make use of a tax advantaged share option plan

Share awards to employees

Employees cannot afford our shares

A successful company's shares can become unaffordable to employees

Possible solutions:

- Split your share capital to create more affordable shares
- Use a SIP to give away shares and/or enable employees to buy shares from pre-tax pay
- Arrange a loan scheme for employees
- Use tax efficient share options as an alternative to share ownership
- Partly-paid share plans?

Operating an internal market

It can be difficult to determine market value

If shares are sold by an employee in excess of market value there is PAYE on the excess

Managing the situation:

- Use an HMRC tax advantaged share plan to obtain regular agreed valuations
- Apply a consistent valuation approach
- Accept that a discount to full value should apply in a private company
- Ensure your constitutional provisions (e.g. the Articles of Association) are consistent with how you wish to value shares
- Accept that HMRC have concerns about the misuse of valuations

Financing employee ownership

Contributions to an EBT

There is a general statutory prohibition on upfront tax deductions for contributions to EBTs

Possible solution

Finance a SIP to acquire 10% or more of the company's shares from an individual shareholder

http://www.hmrc.gov.uk/shareschemes/essa_2002_detail.htm

Financing employee ownership, continued

A problematic solution

“Spotlight 6: Employer-Financed Retirement Benefits Scheme (EFRBS)”

- HMRC are aware of schemes where companies claim a Corporation Tax deduction for employer contributions to an EFRBS scheme on the basis that either (a) the contribution to the EFRBS or (b) a subsequent transfer to a second EFRBS is a 'qualifying benefit'. This would allow the company to secure a Corporation Tax deduction before any benefits are actually paid by the scheme to the employee. **HMRC's view is that neither transaction involves the provision of a 'qualifying benefit'**. Whilst it has been argued that there may be some ambiguity in the law around the meaning of the phrase 'transfer of assets' since it does not state to whom the transfer is to be made, in HMRC's view the context resolves any ambiguity.
- The law defines 'qualifying benefits' and such benefits are plainly, from the context, benefits that if paid under the terms of an EFRBS might fall within the employment income charge. So in that context, a 'transfer of assets' should be interpreted as a transfer that could give rise to such a charge. This will primarily mean a transfer of assets to the employee but also includes a transfer to a member of the employee's family. Neither an employer contribution to an EFRBS nor a transfer between EFRBS gives rise to a possible employment Income Tax charge on the employee. So there is no 'qualifying benefit' entitling the employer to a deduction.”

Operating an internal market

“I cannot benefit from entrepreneur's relief”

Entrepreneur's relief provides a 10% effective rate of CGT but is not available to an employee with a less than 5% shareholding

One solution is to make the most of the CGT annual exemption:

- Realise gains within the annual exemption (£10,100 in 2010-11 tax year)
- Do this every tax year
- Convince your company to permit share transfers to spouses or civil partners so they can also use their annual exemptions

Another solution

Use a SIP and keep shares in the SIP until you sell

Dealing with HMRC

HMRC can help:

- Agreeing market valuations of shares
- HMRC approved share plans
- Tax clearance applications
- Confirming inheritance tax status of EBTs
- Other guidance and rulings

e.g. Form 42 dispensations

But HMRC is always concerned about tax avoidance

The HMRC Employee Shares and Securities Unit (ESSU)

ESSU has kindly provided the following slides to the EOA for distribution at its 2010 annual conference

The ESSU within HMRC has the following responsibilities:

- Policy maintenance and development in relation to tax and employment-related securities.
- Policy maintenance and development in relation to tax-advantaged employee share schemes.
- Approval and monitoring of tax-advantaged share and share option schemes.
- Processing of forms, returns and other information relating to employment-related securities.

The HMRC Employee Shares and Securities Unit

Contact details:

Employee Shares & Securities Unit
HMRC
1st Floor, Ferrers House
Castle Meadow Road
Nottingham
NG2 1BB

E-mail: shareschemes@hmrc.gsi.gov.uk

Information on employee share schemes is available on HMRC website at:

<http://www.hmrc.gov.uk/shareschemes>

Including details on all the tax-advantaged share schemes, including the National Statistics on their usage.

The HMRC Employee Shares and Securities Unit

Why the Government is encouraging employee share ownership

The Government supports employee share ownership arrangements, which can promote productivity by allowing employees an additional stake in the success of their company. Four statutory tax-advantaged schemes – as detailed below – are available for the award of shares and share options to employees

- **Save As You Earn (SAYE)** – SAYE is an all-employee scheme, under which employees can save between £5 and £250 a month from their salary for 3 or 5 years. At the outset of a 3 or 5 year saving contract, a purchase price is set for shares under the scheme. At the end of this contract, a tax-free bonus may be added to the savings, and the employee can use their savings and bonus to purchase shares at this previously-set price.
- **Share Incentive Plans (SIPs)** – Under a SIP, an employee may receive shares free of charge or purchase shares - or some combination of the two - up to a value of £9,000 per year. If shares are held in the SIP for five years, there will be no income tax or NICs liability for the employee. Gains from the shares are also exempt from CGT while shares are held in the SIP.

The HMRC Employee Shares and Securities Unit

- **Company Share Option Plan (CSOP)** – Under CSOP, employers may grant an employee an option over up to £30,000 worth of shares, which can be purchased after a specified period at a price (which must be at least market value) set when the option is granted. Gains made on exercise are free from income tax and NICs provided that options are held for at least 3 years.
- **Enterprise Management Incentives (EMI)** - EMIs are tax advantaged share options for smaller companies (fewer than 250 employees and gross assets not exceeding £30 million). Under EMI, an employer can award employees options over shares with a market value of up to £120,000, subject to an overriding limit of £3m for the company. On exercise of the options, any gains are free from income tax and NICs.

The HMRC Employee Shares and Securities Unit

Share Incentive Plans: Anti-avoidance measure

- The Corporation Tax deduction provisions in section 989 of the Corporation Tax Act 2009 were amended in the March 2010 Finance Act so that CT deductions will not be allowed where a payment to a SIP trust is made as part of a tax avoidance scheme.
- Changes were also made to Schedule 2 to the Income Tax (Earnings and Pensions) Act 2003 in Finance Act No.1 2010 to allow HMRC to withdraw approval of a SIP where the value of shares held in the SIP trust is materially affected by alterations to the share capital of the company in question or to rights attaching to the shares. The changes clarify that approval can be withdrawn even where there are no participants in the SIP, or where no shares have been awarded under it, at the time the alteration takes place.

Company Share Option Plans - Change to rules on subsidiaries

- Changes were introduced in Finance Act No.1 2010 to restrict the type of shares which can be used in CSOP. Paragraph 17(1)(c) of Schedule 4 to Income Tax (Earnings and Pensions) Act 2003 was amended so that CSOP share options can no longer be granted over shares in a company which is under the control of a listed company.
- Finance Act 2010 allows companies a transitional period of six months to amend their scheme rules to bring them into line, although in some cases no amendment will be necessary.