



HM Treasury

# Supporting the employee-ownership sector:

summary of responses

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December 2013





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# Foreword

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As announced at Budget 2013 and subsequently consulted on over the summer months, the Government is introducing a package of measures to support employee ownership. These new tax measures support the Government's ambition to encourage growth in the employee ownership sector and greater diversity of business models in the UK economy.

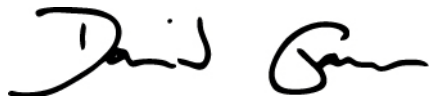
The Government conducted a consultation on the design of these new tax measures over the summer. The consultation document published in July emphasised the Government's commitment to introduce measures that are easily understood and operated by business owners and employers, and to design the reliefs with this in mind.

I am very pleased that we were able to announce additional funding to support employee ownership at Autumn Statement, taking the total increase in support for direct and indirect employee ownership to £75 million per annum.

I am grateful to the interested parties – particularly those from within the employee ownership sector itself – who participated in the consultation, submitting detailed and considered responses about the size and nature of the employee ownership sector and their priorities for the planned measures.

The Government's response to the consultation provides a summary of those responses and sets out the key decisions made on the design of these measures. I am confident that, alongside the excellent work done by the Department for Business, Innovation and Skills over the last year these measures will help to support and raise awareness of the indirect employee ownership sector.

I would like to invite all interested parties to work with the Government to ensure that the draft legislation meets its objectives before introduction in Finance Bill 2014.



David Gauke MP  
Exchequer Secretary to the Treasury





# 1

## Introduction

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**1.1** At Budget 2013, the Government announced that it would provide £50 million annually from 2014-15 to incentivise growth of the employee ownership sector. The policy consultation 'Supporting the employee ownership sector' proposed two tax measures to achieve this: a capital gains tax relief and a tax exemption for employees on bonus or equivalent payments.

**1.2** Autumn Statement 2013 announced a further £20 million to fund these tax measures, following concern from the sector that the original funds would not allow for a sufficiently generous exemption. In addition, a further £5 million has funded an increase to the limits of two direct employee ownership schemes, Save as You Earn and Share Incentive Plans, taking the total increase in support for employee ownership to £75 million per annum.

**1.3** The aims of the consultation, which ran from 4 July to 26 September 2013, were to discover how best the Government could implement its proposals to support the sector and to gather information which would help to improve the Government's understanding of the size and makeup of the sector.

**1.4** The consultation focused on tax reliefs to support the indirect employee ownership sector, of which there is a much lower level of public awareness than that of the direct employee share ownership sector. The Government recognises the importance of both forms of employee ownership. However, the Government is mindful that a great deal of support is already provided to direct employee share ownership through a number of different schemes that provide tax advantages. The new measures outlined in this document are intended to support the much smaller indirect sector, in order to encourage a greater diversity of business models.

**1.5** Around 70 responses were received from a wide range of stakeholders: existing employee owned companies; companies considering a move to employee ownership; agents; representative bodies and experts on the sector. A list of respondents is available at Annex A.

**1.6** The Government is grateful to all those who responded to the consultation. Stakeholders engaged constructively with the consultation, and the responses have been valuable in designing the tax reliefs and the qualifying criteria.

**1.7** Draft legislation was published on 10 December and the Government welcomes technical comments on this by 4 February 2014. Comment should be sent to: [capitalgains.taxteam@hmrc.gsi.gov.uk](mailto:capitalgains.taxteam@hmrc.gsi.gov.uk).

**1.8** This document provides a summary of consultation responses received and explains how these have informed the Government's approach to supporting the indirect employee ownership sector through the tax system. It then sets out the basic structure of the reliefs and qualifying criteria.

### Proposals

**1.9** As set out in Autumn Statement 2013, from April 2014, disposals of shares that result in a controlling interest in a company being held by a qualifying trust will be relieved from capital gains tax.

**1.10** From October 2014, bonus payments made to employees of companies which are controlled by a qualifying trust will be exempt from income tax, up to a cap of £3,600 per annum.

**1.11** The consultation referred to the use of an employee benefit trust (EBT) as a qualifying trust. However as that document recognised, while the use of an EBT in its own right does not constitute avoidance, it is important that any new relief that could promote greater use of EBTs is accompanied by appropriate safeguards.

**1.12** For that reason, the Government is proposing further requirements in order for EBTs to be qualifying trusts for the purposes of the income tax exemption and capital gains tax relief. Such trusts are referred to in this document as **employee ownership trusts (EOTs)**.

**1.13** Further detail on EOTs, qualifying criteria, the relief and the exemption are outlined in Chapter 3.

**1.14** The key changes arising from the consultation period can be summarised as:

- increased funding for the package of reliefs;
- revised design of exemption from income tax. Following feedback from the sector that it would be preferable for the benefit of the exemption to be focused on employees rather than on employers, the Government has decided that there should be no exemption for employer's or employee's National Insurance contributions on qualifying payments to employees;
- greater flexibility on the CGT relief, specifically around the number of individuals to whom relief will be available; and
- clarification of the qualifying criteria for both the CGT relief and the income tax exemption.

# 2

## Responses

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**2.1** This chapter summarises the questions posed in the consultation, the submissions received, and sets out the Government's response.

**2.2** A small number of questions appear in a different order from that in which they appeared in the original consultation. As they drew very similar responses from stakeholders, they are grouped together in order to avoid repetition and to allow for the provision of a coherent response. Where questions have been switched, this is indicated.

### Learning about the sector

**2.3** This section sought to gather data on the size and nature of the sector, in order to inform the design of the proposed tax relief and exemption.

#### Question 1

If you have an interest in an indirectly employee-owned business or company, what is its structure? How long has the business existed in its current structure? Was it created in an employee-owned structure or converted at a later stage?

**2.4** There was a wide range of responses to this question, from companies, solicitors, accountants and advisors. Respondents outlined a number of differing indirect employee ownership structures that currently exist.

**2.5** The structures described by the respondents have evolved in various ways. The vast majority of respondents stated that the companies which they represented were not set up in employee ownership structures, but converted to them at a later stage. There were various reasons given for transitioning to an employee ownership structure, including succession solutions and a strong belief on the part of the owners that it was in the long-term interest of the company and its employees to do so.

#### Question 2

How does the trust own the company? Is the company owned directly through its shares? Are these shares equivalent to ordinary shares? What proportion of the company is owed by an employee benefit trust (or other ownership vehicle)? Who does the trust benefit – is it all employees or just some? Is it used to reward all, or some employees?

**2.6** In cases where a company's shares were owned by a trust, it is clear that the proportion of the shares owned by the trust varies a great deal between companies. The Government received responses from companies in which between 10 per cent and 100 per cent of the company's shares were owned by a trust for the benefit of employees.

**2.7** Some of the companies in which an employee benefit trust (EBT) currently holds less than 100 per cent of the issued share capital stated their intention to transfer further shares into the trust in the future. In other cases, there were hybrid structures, with some of the shares being owned by an EBT, and others being owned directly by employees.

**2.8** A majority of those who said that the shares were held by an EBT confirmed that these shares were equivalent to ordinary shares.

**2.9** The Government also received responses from companies in which there was no trust, but in which employees owned shares directly.

**2.10** The majority of respondents to the question regarding whom the trust is intended to benefit stated that the trust was for the benefit of all employees. There were also some responses from companies whose trust existed for the benefit of employees but also permitted some former employees (“good leavers”) to benefit.

### **Question 3**

Do you agree that the nature of an employee-owned business or company helps the business to be successful? Can you explain why you think that is the case?

**2.11** Respondents felt strongly that employee ownership helped businesses to be successful. A number of respondents qualified their belief that employee ownership helped the business to be successful by saying that the employee’s role in the business must be properly structured and communicated in order to do so.

**2.12** There was general consensus that employee ownership has a number of benefits, including greater commitment and productivity, lower staff turnover and greater stability. Some respondents felt that the structure was particularly beneficial to long-term business planning, allowing more scope for internal investments and growth.

**2.13** There were a variety of reasons given for the benefits of employee ownership. Some respondents felt that employees being part of a team with a shared purpose, rather than having a strong distinction between managers and workers, was the principal driver of increased productivity. The fact that the employees in employee ownership structures are sometimes able to see a direct personal benefit from their work was also cited as a reason for greater efficiency. A number of respondents also held that employee ownership structures increased staff loyalty and promoted low turnover.

**2.14** Other respondents argued that the absence of pressure to return a dividend to external shareholders allowed the company to take a more strategic, longer term approach.

### **Question 4**

How large is the business in terms of number of UK based employees?

**2.15** The majority of respondents were part of small employee owned businesses, with fewer than 500 employees. However, there were a few larger companies which also responded.

### Question 5

If you do not have an interest in an employee-owned business, would you consider acquiring such an interest, or converting to an employee-owned structure, in the future? Why/why not? What would encourage you to do so?

**2.16** Some respondents to this question were already planning conversions to employee ownership structures, generally as a means of succession planning.

**2.17** There was a general feeling that the tax relief and exemption could encourage businesses owners to consider conversion to an employee ownership structure. However, some respondents cautioned that employee ownership may not work for all business sectors and business models.

### Question 6

Are you a professional advisor? If so, do you see many indirectly employee-owned companies? Do you think this number is likely to increase? What more could be done to increase the number? Will these reliefs help?

**2.18** Most professional advisors agreed that they did not see many companies in indirect employee ownership structures at the moment, and there was considerably more interest in direct forms of share ownership.

**2.19** However, several respondents agreed that interest in employee ownership structures was increasing generally, and they felt that the proposed relief and exemption had the potential to increase the interest in indirect forms of ownership.

**2.20** Reasons cited for the current lack of interest in indirect employee ownership were: cost and complexity of set-up, lack of familiarity with the law, and the difficulty in obtaining finance to acquire the shares.

### Question 7

Did the Budget announcement raise awareness of the employee ownership sector?

**2.21** The general feeling in response to this question was that the Budget announcement had made some impact, although a few respondents suggested that this was less the case outside the employee ownership sector. There was a general consensus that the introduction of the relief and exemption will be the key moment for awareness-raising.

**2.22** As highlighted in the response to question 6, awareness of indirect employee ownership structures is currently relatively low. Once the CGT relief has been introduced, tax advisors will be obliged to mention that a sale of shares giving control of a qualifying company to a qualifying indirect employee ownership structure may entitle the sellers to relief from CGT.

### Government response

**2.23** The Government is grateful for the responses we have received to questions in this section. These have been very useful in considering the designs of the relief and exemption, and how they will be applied to the diverse models of indirect employee ownership which currently exist in the UK economy.

**2.24** The Government recognises that there is a great diversity of indirect employee ownership models. In order to keep the legislation simple, the legislation refers to a single model – that of indirect employee ownership through an employee ownership trust (EOT). More detailed information on the qualifying criteria is set out in Chapter 3.

## Qualifying criteria and operation of the relief

**2.25** There were a number of questions which sought views on the Government's proposals for the nature and scale of the ownership which should be held for the benefit of the employees in the business in which they work. This section summarises stakeholders' responses to these questions and explains how the Government has used these to inform the final design of the qualifying criteria.

### Question 8

Do you agree that the qualifying criteria should be expressed by reference to the proportion of shares with voting rights held by an employee benefit trust? Do you agree that the criteria should also look at the trust's entitlement to assets on liquidation or winding up?

**2.26** Broadly, respondents agreed with this approach on the grounds that these are familiar and widely-understood concepts. There was strong support for a definition that relied on the trust benefiting from both the voting rights and economic interest in the company, with some suggestion that focusing solely on voting rights might leave the reliefs open to abuse.

**The order of questions 9 and 10 below has been reversed from the original consultation document.**

### Question 10

Do you agree that a simple majority of voting power carried by the company's issued share capital (referred to here as '51 per cent') is an appropriate level of control? If not, please explain why not.

**2.27** Most respondents agreed, especially those representing companies which are already in an employee ownership structure. Some thought a higher level of ownership was more appropriate. Some suggested 75 per cent, as that would allow the trustees to carry a special resolution, and might demonstrate a greater level of commitment to the principles of employee ownership.

**2.28** However, others thought that insisting on such a high level of share ownership by the EOT would be off-putting to many businesses as too high a barrier. The challenge of raising sufficient funds for an acquisition of this size by the EOT was also mentioned, along with the risk that companies might take on too much debt in order to finance an acquisition of this size.

**2.29** Some respondents thought it should be made easier to claim the relief by setting a lower threshold. These respondents generally made the point that a much lower level of share ownership by the EOT, for example 30 per cent, can still be meaningful as long as the right structures are in place.

**2.30** Some stakeholders made more complex suggestions, such as introducing a 'sliding scale' of CGT relief.

**2.31** Strong support for the indirectly owned shares to carry economic as well as voting rights was also expressed by several stakeholders in response to this question.

**2.32** A small number of respondents also indicated that they would be keen to see a definition which involved requirements concerning the mechanism through which the employee voice could be heard, for example requiring that at least one trustee should be elected by employees.

### **Government response**

**2.33** The responses received from stakeholders indicate that there is a diversity of opinions on what should constitute a controlling interest held by an EOT for the purposes of the proposed tax relief and exemption. The Government's priorities in this area are to:

- ensure that the controlling interest in the company owned by the EOT demonstrates genuine commitment to the principles of employee ownership; and
- avoid overly complex definitions.

**2.34** For these reasons, the Government believes that it is right to define a qualifying structure as one in which an EOT holds a controlling interest in a company which is either a trading company or, if it is the parent company of a group, a member of a trading group.

**2.35** The legislation will define a controlling interest as a simple majority, i.e. more than 50 per cent of the company's ordinary share capital. The trustees must hold shares forming part of the ordinary share capital of the company and which:

- comprise more than 50 per cent of such ordinary share capital;
- carry the right to more than 50 per cent of the voting powers on questions affecting the company;
- carry the right to more than 50 per cent of profits available to be distributed by the company by way of dividend; and
- carry the right to more than 50 per cent of the assets available for distribution on a winding up of the company.

**2.36** The Government acknowledges the point made by some respondents that a lower level of share ownership by the EOT can be meaningful if the right structures are in place. However, identifying and legislating for structures of this sort would be very complex, and very challenging given the diverse nature of indirect employee ownership structures in use.

### **Employee voice**

**2.37** After careful consideration, the Government has decided that the fact that the trustees of the EOT must have a controlling interest in the company and must act for the benefit of virtually all employees in order for the relief or exemption to be available should sufficiently enable and encourage the trustees to represent employees. Alongside concerns that it would be very complex to legislate for, there is a question over whether introducing tax legislation would be the appropriate method to promote the employee voice. The mechanism by which employees are given a voice will depend on the terms of the trust deed establishing the EOT, the company and culture in question.

### Question 9

Can respondents suggest criteria by which to exclude companies which are already controlled by employees by reason of their shareholding in the company?

**2.38** The Government was concerned that the CGT relief and income tax exemption should be available only where there is an actual transfer of control of a business to employees, or where control is held and exercised on behalf of employees who would not otherwise have a material say in the conduct of the business in which they work.

**2.39** This question drew various suggestions from stakeholders. Some respondents thought that it would make sense to exclude those companies in which there were no employees as such, but only directors and senior managers. Another suggestion was that companies should be excluded if they did not have an elected employee representative on their board. Some stakeholders suggested that the income tax exemption should only be available in cases where payments were made to employees who were not participants in the company.

**2.40** Several respondents felt strongly that the blanket exclusion of all companies with – for instance – five or fewer employees might unfairly penalise smaller businesses looking to expand. However, a few respondents felt that excluding companies in which there were five or fewer employees would be appropriate.

### Government response

**2.41** In order to prevent the CGT relief from being claimed where many of the employees are already office-holders or owners, and thus a sale might not represent a genuine transfer of control, the Government has decided that in such cases relief may not be claimed where an individual has been a substantial participator in the preceding twelve months. A ‘substantial participator’ holds or is entitled to five per cent or more of any class of share comprised in the company’s share capital, and would have been entitled to more than five per cent of the company’s assets on winding-up. After the trust has assumed control of the company an employee who is, or has in the ten years before the disposal, been a substantial participator may not be a beneficiary of the trust. This restriction will not apply to the income tax exemption.

**2.42** In order to protect against repeated use of the relief, the CGT relief will not be available to a person disposing of shares in a company to an EOT if relief has been given on another disposal in a previous year by the same person (or by a connected person) of shares either in the same company or in a company which was a member of the same group of companies at the time.

## Capital gains tax relief

### Question 11

Is there a case for allowing the relief to other types of person liable to CGT, such as trustees? In what circumstances would those persons wish to dispose of a qualifying interest in a company to an employee benefit trust?

**2.43** In general, respondents felt that there was a case for allowing trustees to claim the relief in order to encourage the disposal of shares into employee ownership structures.

**2.44** Several respondents agreed that extending the relief to trustees as well as other persons liable to CGT would be particularly useful for family companies.



## Government response

**2.45** A number of respondents were keen to see trustees qualify for the CGT relief. The Government proposes extending the relief to trustees. One reason for doing so is that existing EBTs which do not meet the conditions necessary for the income tax exemption may wish to settle their assets on new trusts which do meet the conditions. Another reason is that shares in 'family companies' may be owned by family trusts.

**2.46** The CGT relief, where available, may also be claimed by the personal representatives of deceased individuals who sell shares in a qualifying company to an EOT.

### Question 12

By how much would take-up of the CGT relief be increased if it were available to more than one transferor on the bases described?

**2.47** The Government's original proposition was that CGT relief should be available only on a single disposal by a single individual. Although recognising that there may be cases in which this would not be practical, the Government's priority must be to strike a balance between designing an appropriate relief and protecting against potential avoidance risks.

**2.48** A high number of respondents to the consultation stated that disposals into indirect ownership structures tend to be made by a number of different parties and over a number of years. Respondents felt strongly that allowing relief on such disposals would be very important to the success of this relief.

**2.49** Some stakeholders felt that the availability of the CGT relief to more than one transferor would be essential to the success of the relief. Several respondents made the point that it could be difficult, if relief were restricted to one individual, for shareholders to determine who would benefit from the relief. Family companies in particular were cited as likely examples of companies which would need to accommodate disposals by more than one shareholder.

**2.50** A number of respondents also felt that relief should be available over a number of years, as shareholders gradually disposed of a controlling interest. These respondents felt that this was a more usual method of disposing of a controlling interest because of the need to raise finance.

## Government response

**2.51** The Government has considered these issues very carefully, and concluded that it will be possible to accommodate the request to take account of share disposals within the same tax year by different people, as long as those disposals contribute to a controlling interest held by an EOT at the end of the tax year, providing the trust has not held a controlling interest at the start of the tax year or previously.

**2.52** The Government does not believe it will be possible to allow CGT relief for disposals that take place over a number of years and which add up to a controlling interest. Doing so would create significant avoidance risks and pose considerable administrative challenges. The greatest challenge would be the difficulty of withdrawing any relief that had already been claimed if the necessary level of employee ownership was not achieved by the trust within a specified period, or if other conditions ceased to be met.

**2.53** For example, if a majority shareholder began to sell shares to a new trust at a rate of 10 per cent per year, intending to sell 70 per cent over seven years, the trust would not acquire a controlling interest until after the sixth disposal. The tax treatment of the first five disposals would

be problematic, as the eventual satisfaction of the conditions for relief would not be guaranteed when they were made. Even if there were a binding contract made in year one to sell the entire 70 per cent, then the trustees would still only have a controlling interest at the end of the tax year in which they acquired more than 50 per cent of the share capital of the company.

### **Question 13**

Should the CGT relief be available on disposals of unincorporated businesses, as well as disposals of ordinary share capital in a company? How would extending the relief in this way increase the likely number of qualifying disposals?

### **(Originally question 16)**

If the Government decides to extend the CGT relief to disposals of unincorporated businesses, how should a controlling interest in such businesses be defined so as to guarantee that an appropriate stake in the business is acquired by the trust?

**2.54** Discussion of this question drew a mixed response from stakeholders, although there was not widespread support for extending the relief to unincorporated businesses.

**2.55** A few stakeholders highlighted the need to encourage transfers into employee ownership as widely as possible, suggesting that the relief should be extended to unincorporated businesses. Others thought that making the relief available to unincorporated businesses could create practical problems, suggesting that it would be complex and potentially open to abuse.

**2.56** At least one respondent suggested that there was little need to extend eligibility for the relief to unincorporated businesses, as taking on the liabilities associated with unincorporated businesses would be commercially unattractive to trustees.

**2.57** A few respondents felt that, although broadening the relief would be welcome, given the fixed amount of funding available, it might stretch the funds available and thus dilute the level of the income tax exemption to a point at which it became less attractive.

**2.58** The majority of respondents did not feel that there was a need for the relief to be made available to unincorporated businesses.

### **Government response**

**2.59** The Government has decided not to extend the relief to unincorporated businesses. Responses to the consultation did not indicate that there was a strong commercial need to do so, and the Government is keen to avoid unnecessary complications to the legislation.

### **Question 14**

Would any other definition of 'controlling interest' be preferable in connection with the CGT relief?

**2.60** The Government proposed that for these purposes 'controlling interest' should mean shares which together give the holder the power to exercise more than one half of the voting power in the company.

**2.61** The majority of respondents agreed that this definition was the most practical and appropriate for the purposes of the CGT relief. There were again some suggestions from respondents that the level should be set lower than 51 per cent, but these were in the minority.

### Question 15

What do you see as the risks and advantages of the simple '51 per cent' definition and any possible alternative definitions? How would the number of claimants vary with the possible definitions?

**2.62** There was a range of answers to this question. Although there was broad support for setting the level at 51 per cent, some respondents thought there was a risk that this could discriminate against companies which were moving to employee ownership slowly, with multiple share disposals over a number of years.

**2.63** Some respondents also made the point that if the number of eligible businesses was only very small, then the beneficial effect as a whole could be limited.

**2.64** At least one stakeholder felt that the level should be much lower than 51 per cent, and asserted that as little as ten per cent would be enough to meet the objective of genuine employee engagement in the business.

### Government response

**2.65** On balance, the Government feels that more than 50 per cent is the most appropriate level of control. It balances the need to ensure that the trust and the company are genuinely committed to indirect employee ownership against the risk that only very few businesses, potentially larger companies with greater access to finance, will qualify.

**2.66** If the definition were to be set at a much lower level, there might be a risk that some companies become "partially indirectly employee owned" by the trust, without the trust and the company pursuing genuine employee engagement.

**2.67** On the other hand, to set it higher might disqualify a number of businesses which do indeed have this genuine engagement but for which, for whatever reason, a higher level of share ownership by the EOT is not possible or appropriate.

**2.68** Of course, there would be risks and advantages at whichever level 'a controlling interest' were to be set. However, the Government is attracted to the simplicity of a 'more than 50 per cent' definition, and believes this to be the most appropriate definition of a controlling interest for the purposes of the CGT relief and the income tax exemption.

### Income tax exemption

**2.69** The principal concern which arose in connection to the income tax exemption was that the £50 million per annum funding, which was announced at Budget 2013, would not allow for a sufficiently generous exemption. The Government recognises the arguments that were made in support of this point, and has increased the available funding to £70 million per annum from 2014-15.

### Question 17

How should the type of payments that qualify for the new exemption be defined?

**2.70** There was a range of suggestions in response to this question, with respondents broadly in agreement that payments should in some way represent a share of profits.

**2.71** Some respondents also suggested that payment should be based on a fixed formula applicable to all employees.

**2.72** A number of stakeholders were concerned that being too prescriptive about the nature of the qualifying payments would lead to excessive burdens on companies, by requiring them to disclose profit and loss accounts in order for the exemption to be justified.

### **Government response**

**2.73** The policy rationale for this exemption is that it allows the company to share its successes with its employees by way of tax-advantaged payments, so the Government would like the exemption to be available in respect of a bonus or similar payment. However, there is a strong case for keeping the exemption as simple as possible, and the Government does not intend to require a direct link between profit distribution and the relevant bonus.

**2.74** The definition of a qualifying payment will therefore not be overly prescriptive or require disclosure of a profit and loss account.

**2.75** However, the legislation as published in draft specifies that the exemption cannot apply to anything which is regular salary or regular wages. This stipulation is intended to ensure that the exemption only applies to the sort of payments at which the policy is aimed. It would not be in keeping with the policy rationale of introducing a tax advantage for companies to share their profit with employees if employers were to use the exemption as a means of distributing regular salary in a more tax-efficient fashion, or to suppress wages artificially and use (partially) exempt bonuses to make up the shortfall.

**2.76** The Government recognises that employers may wish to reward employees to different degrees and so will not require that all employees must receive identical payments in order for the payments to qualify for the exemption. The amount of a payment to a particular employee may be determined by reference to the employee's overall remuneration, to his or her length of service or to the number of hours worked.

**2.77** However, although they need not benefit by identical amounts, if any employees are to benefit then all employees of the company or, as the case may be, the group must benefit, and they must all benefit on the same terms.

**2.78** It is the Government's intention that this will prevent employers from using the income tax exemption to reward disproportionately certain groups of employees but not others.

#### **Question 18**

The Government expects that, in most cases, payments will be made directly to the employee from the employing company but it is aware that employers may seek to make different arrangements. The Government is considering whether the exemptions should apply where the payments are made by the trust [EOT], although it recognises that this may involve complex legislation. If the exemption were limited to payment made by an employing company would this provide sufficient flexibility? How could the exemption be effectively extended to payments made by trusts?

**2.79** In common with responses to many of the questions, there was strong support for simplicity in response to this question. Most argued for limiting payments to those made by the employer company, rather than including those made by the trust. The majority of respondents believed that this was the most straightforward approach, and that there was no strong commercial rationale for allowing the trust to make qualifying payments.

**2.80** A small minority of respondents felt that the exemptions should also apply in cases where payments were made by the trust.

### **Government response**

**2.81** The Government feels that there is no strong case for allowing qualifying payments to come from the trust rather than the company, and that there are a number of arguments against allowing this, principally that it would add a great deal of complexity to the legislation.

**2.82** The Government has therefore decided to apply the exemption to payments from the employing company, rather than the trust, in the interest of legislative simplicity.

#### **Question 19**

Do you agree that the proposed outline of the way the exemptions will operate is fair and straightforward for the employer to understand and implement?

**2.83** There was broad agreement on this point, although some respondents mentioned that the exemption will be more difficult for smaller businesses to operate than for larger organisations.

**2.84** A number of respondents were keen to highlight the importance of maintaining simplicity in the design and operation of the proposed exemption. There were also several suggestions about how to ensure that the exemptions are genuinely used for the benefit of all employees.

**2.85** Some respondents highlighted risks to fairness. These included the risk that the exemption would artificially suppress wages as the tax consequences would be factored in, and employers could deliver an identical post-tax salary to one provided by a non-qualifying employer, at a lower cost.

**2.86** Some respondents suggested that relief could be restricted to the basic rate of tax only, so that higher rate taxpayers did not benefit by more than basic rate taxpayers.

**2.87** Additionally, there were some concerns about the future – if the exemption succeeds in encouraging the employee ownership sector to grow, then more companies will qualify and the cost of the exemption will grow beyond the allocated amount.

### **Government response**

**2.88** The Government has revised the design of the exemption such that it will be an exemption only from income tax and not from employer's and employee's NICs. This allows for a higher income tax exemption, with the benefit focused on employees rather than employers.

**2.89** Exempt payments may be made in instalments, for example as monthly or quarterly 'bonuses' or as a single annual sum. The exemption will apply only to cash payments, and not to other transfers of value, such as shares.

**2.90** The Government has decided that the exemption will be given at the marginal tax rate of the individual receiving the payment – at the basic rate of tax for basic rate taxpayers and the higher rate of tax for higher rate taxpayers.

**2.91** This is in the interests of maintaining operational simplicity for employers, which was a strong theme emerging from responses to the consultation. Any attempt to restrict the exemption such that it was available at the restriction to basic rate only would involve significant complexity and would be likely to impose a high administrative burden on employers in terms of applying and recording use of the exemption.

**2.92** The exemption will not be available for a bonus or equivalent payment paid under salary sacrifice arrangements. The Government believes that this will help to reduce the risk of artificially suppressed wages and employers using the exemption to lower the overall costs of employment.

**2.93** The Government is considering reviewing this exemption in five years time to monitor take up, effectiveness and whether the spend is at the appropriate level. Suggestions are welcome on how it would best to do this.

# 3

## Structure of the relief and exemption; qualifying criteria

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**3.1** This chapter provides an overview of the draft legislation. It gives details of the CGT relief and the income tax exemption, and the criteria which a trust and a company will need to meet in order to qualify for these.

### Capital gains tax relief

**3.2** Capital gains tax (CGT) is charged on gains which accrue when chargeable assets are disposed of by an individual. A sale or a gift of shares is normally treated as a disposal and a taxable gain or allowable loss will normally accrue, so a shareholder who sells shares may be liable to CGT on his or her gains. The principal rates of CGT are 18 per cent and 28 per cent, but in many cases relevant to the consultation the effect of entrepreneurs' relief will be to reduce the rate of CGT on a disposal of shares to 10 per cent.

**3.3** The Government proposes that, subject to certain conditions, gains on disposals of shares to a qualifying employee ownership trust ("EOT") should be relieved from CGT where the disposals contribute to the creation of a controlling interest in the company being held by the EOT. Disposals of the ordinary share capital of the company to an EOT within a tax year will be eligible for the relief, provided that:

- the EOT did not at any time before the beginning of that tax year have a controlling interest in the company;
- but did so at the end of that tax year;
- the company is a trading company or the holding company of a trading group and remains so until the end of the tax year in which the disposal is made;
- neither the person making the relevant disposal nor any person connected with him must have made a disposal in a previous tax year of any shares either in the company or in any other company which at the time of that earlier disposal was a member of the same group as the company; and
- **either** the person making the disposal must not at any time within the 12 months ending immediately after the disposal be a 'substantial participator' or fewer than two-fifths of the total number of employees and office-holders in the company must be substantial participators immediately after the disposal. (A 'substantial participator' holds or is entitled to five per cent or more of any class of share comprised in the company's share capital, and would have been entitled to more than five per cent of the company's assets on winding-up.)

**3.4** The relief will work by treating the person making the disposal as having disposed of the shares, and the trustees as having acquired the shares, for an amount which gives rise to neither a gain nor a loss to the person making the disposal. Where the relief is available it may be claimed by individuals, personal representatives of a deceased shareholder or trustees of a trust. If the trustees of the EOT cease to control the company, or certain other events occur which mean the EOT ceases to be a qualifying trust, the trustees will be deemed to have disposed of

and reacquired all of its shares in the company at the then market value and any gains realised by the trustees on such a deemed disposal will become chargeable to CGT.

**3.5** The introduction of this relief will mean that advisors will be obliged to mention to the owners of companies that selling their shares into an EOT may be tax-advantaged if doing so contributes to the EOT acquiring control of the company, which will raise awareness of the model. The intention is that the relief will make indirect employee ownership an attractive proposition for those who are looking to dispose of a controlling interest in their company.

**3.6** This CGT relief will provide an incentive for the creation of new indirect employee ownership structures, and the strengthening of existing indirect employee ownership structures.

## **Income tax exemption**

**3.7** The Government's intention is to provide an exemption from income tax on bonus or equivalent payments made by a company in an indirectly employee owned structure to its employees, up to a cap of £3,600 per tax year.

**3.8** This exemption will be available to employees of any company in which an EOT owns a controlling interest or which is a member of a group headed by such a company, provided the company meets the qualifying conditions.

**3.9** The conditions include a requirement that all employees in the company or, as appropriate, group of companies must be treated in the same manner. Although the exemptions are only available if an EOT has a controlling interest in the company or, as appropriate, parent company, they do not depend on CGT relief having been available on disposals of shares in that company to the EOT.

**3.10** The exemption will only apply to payments made directly by an employer and not to payments made by the EOT.

**3.11** The Government wants to use this exemption to support and promote the indirect employee ownership sector and intends that it will apply only to cash payments, and not to other transfers of value, such as shares.

**3.12** To mitigate any risk of the exemption being exploited to lower an employer's overall costs of employment, it will not be available for a bonus paid under salary sacrifice arrangements.

**3.13** Exempt payments may be made in instalments, for example as monthly or quarterly 'bonuses' or as a single annual sum.

**3.14** Relief will be given at the marginal tax rate of the individual receiving the payment. Although there was some encouragement from stakeholders that the exemption should be available only to basic rate taxpayers, or that relief should be available only at the basic rate. The Government felt that this was outweighed by the need to maintain simplicity.

## **National Insurance contributions**

**3.15** The original proposition was that the annual exemption would apply to both income tax and NICs. However, this would have led to a lower annual exemption being available to employees. A number of stakeholders expressed the view that they would prefer the benefit to be focused as far as possible on employees rather than on employers; if the exemption had included NICs, then over half of the benefit of this would have accrued to employers rather than employees.



**3.16** With this in mind, the Government has revised the design of the exemption to exclude NICs. This will lead to slightly greater operational complexity, but the Government does not believe that this will place significant burdens on employers.

## **Level of exemption**

**3.17** The level of the annual exemption from income tax has been set at £3,600. The indicative figures provided in the original consultation document were considerably lower than this, partly because the Government's information regarding the size of the sector was at the time incomplete and partly because a NIC exemptions was included.

**3.18** These low indicative figures provoked concern in the sector, that if the exemption were not to be set at a meaningful level, then it might not successfully support the sector.

**3.19** The Government was mindful of these concerns, and so has increased the amount of funding available from £50 million per annum to £70 million. This, along with the removal of employer's and employee's NICs from the exemption has allowed for a considerably more generous exemption from income tax than was originally thought achievable.

## **Eligibility for exemption**

**3.20** In order to be eligible for the exemption, a bonus or equivalent payment must be paid to an employee by a company which, throughout the qualifying period, has been controlled by an EOT (see paragraph 3.26) and has met the qualifying conditions (see paragraph 3.35). The qualifying period will usually be the 12 months prior to the date of payment but where the EOT has not been in existence for a full 12 months or first acquired a controlling interest in the company during this period a shorter period will apply.

**3.21** To prevent employers from using this exemption to reward disproportionately a particular group of employees, the Government wants all employees of the company (or group) to be eligible to receive a bonus payment on equal terms.

**3.22** The Government accepts that some companies may have probation arrangements for new employees, so will enable a company to choose to exclude those who have commenced employment within the previous 12 months without breaching this requirement.

**3.23** Bonuses paid to employees are not required to be equal and can be set by reference to a percentage of salary, length of service or hours worked. However, payments cannot be used to reward solely or disproportionately certain groups of employees, such as directors or higher paid executives.

**3.24** To minimise the risk of service companies being set up to benefit from the tax exemption without allowing any genuine employee ownership, bonus payments made by either a Managed Service Company or a company that provides all, or a majority, of its services to a company that used to own it or employ its employees, will not be eligible for the exemption. This exclusion will not apply to companies providing services within a group of which they are a member.

## **Corporation tax**

**3.25** The Government will also introduce legislation to ensure that exemption from income tax does not disqualify paying companies from claiming corporation tax relief for which they would ordinarily be eligible in respect of bonuses paid directly to their employees.

## Employee ownership trusts (EOT)

**3.26** The assumption set out in the consultation was that the structures at which the relief and exemption would be targeted are characterised by the interest in the company being held by trustees of an employee benefit trust (EBT) for the benefit of employees of the company or group.

**3.27** Although the sort of trust these measures are intended to encourage will be EBTs, the Government believes that it will be necessary to regulate the activity and discretion of their trustees to a greater degree than currently applies for EBTs.

**3.28** Trusts which meet the conditions for the income tax exemption and CGT relief to be available are referred to as 'employee ownership trusts' (EOTs).

**3.29** Subject to the following paragraphs, for a trust to be an EOT it must operate only for the benefit of all employees of the company or group which it controls and will be restricted in the manner in which they can make distributions of trust assets (income or capital) to employees, in that any distribution must be made to all eligible employees of the company (or group) on the same terms.

**3.30** Certain substantial participators in the company, and persons connected with them, will not be allowed to be beneficiaries of the EOT.

**3.31** Trustees will be permitted a limited discretion to exclude as beneficiaries new employees on probation or an employee who specifically requests to be excluded from a particular proposed distribution of assets by the trustees. This may be necessary for companies which operate internationally and might otherwise face complex regulatory issues.

**3.32** Trustees will be permitted to apply settled property (including income arising from it) for charitable purposes as well as for the benefit of employees on the basis outlined above.

**3.33** The Government recognises that the deed establishing an EBT will grant trustees wider discretion than would be possible for a trust whose governing deed written to agree with the EOT requirements. The Government does not wish to compel existing EBTs to amend their trust deeds. The Government is therefore considering ways in which it may be possible for the eligibility of such trusts to be judged on behaviour (i.e. whether the trustees have acted in all material respects as though they were trustees of an EOT throughout a specified period) rather than by reference to the terms of their trust deeds, and intends to publish legislation in the new year.

**3.34** Some existing EBTs will be incapable of meeting the EOT requirements, for example because they are incapable of benefitting all of the employees of the company, or group. In these circumstances the trustees will need to amend their Deeds, or resettle property in a new trust if they wish ordinary shares in the capital of the company held by them to come to be held by a trust which qualifies as an EOT. If this is done and it gives rise to an actual or deemed disposal by the trustee of the relevant EBT of ordinary share capital in the company then, provided conditions similar to those referred to above are satisfied then relief from CGT will be available.

## Activities of eligible employee owned companies

**3.35** In order for the exemption (and the CGT relief) to be available, the company which the EOT controls must be either a trading company or (if it is a member of a group of companies) the principal company of a trading group.

**3.36** The requirement that the company must carry on a trade on its own account is intended to protect against the risk of avoidance by companies which merely hold a small proportion of

another company's shares becoming employee-owned and qualifying for the reliefs without any genuine transfer of control of a business to employees.

## **Inheritance tax exemption**

**3.37** Transfers of shares by an individual or a close company into a trust for less than their full market value would normally be immediately chargeable to inheritance tax (IHT) under the relevant property regime. The trust would also be subject to IHT charges every ten years and again when property was taken out of the trust.

**3.38** However, transfers of shares and other assets to EBTs and the property in EBTs are exempt from such IHT charges, providing certain conditions are met. To encourage owners of a company or of a holding company in a group structure to sell their controlling interest into an EOT, the conditions for the EOT will be such that they will normally meet the qualifying conditions for the existing EBT exemption, meaning that the EOT would be exempt from IHT charges.

**3.39** Where the EOT does not meet the qualifying conditions for the existing EBT exemption, the Government is amending the IHT legislation to ensure that an EOT will qualify as an EBT for IHT purposes and will therefore be exempt from IHT charges.

## **Qualifying criteria: the trust's controlling interest**

**3.40** In order for the exemption (and the CGT relief) to be available, the trustees of the EOT must hold a controlling interest in a company which is a trading company or (if it is member of a group) the principal company of a trading group.

**3.41** The legislation will require that the trustees hold more than 50 per cent of the company's ordinary share capital and such shares must:

- carry the right to more than 50 per cent of the voting powers on questions affecting the company;
- carry the right to more than 50 per cent of the profits available to be distributed by the company by way of dividend; and
- carry the right to more than 50 per cent of the assets available for distribution on winding up of the company.

**3.42** There must be no provision in existence for these conditions to cease to be met without the consent of the trustees of the EOT.

**3.43** If the EOT ceases to hold a controlling interest in the company, or otherwise ceases to qualify as an EOT, then the trustees of the EOT will (save to the extent that there is an actual disposal of shares) be deemed to have disposed of all of the shares in the company then held by it, and to have reacquired them at their then market value. This may result in a chargeable gain or an allowable loss being realised by the trustees of the EOT for the purposes of CGT.

## **Stamp duty/stamp duty reserve tax**

**3.44** A number of stakeholders mentioned that the introduction of an exemption from stamp duty and stamp duty reserve tax on transfers of shares to the trustees of an EOT would be welcomed, as it would allow a transition to an indirectly employee owned structure wholly free of tax consequences.

**3.45** The Government recognises that there are some arguments for this. However there are no precedents for an exemption from stamp duty in other tax-advantaged employee ownership share plans, and so introducing such an exemption for indirect employee ownership structures could create demand for a much wider exemption that was envisaged by respondents to this consultation.

# A

## List of respondents

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**A.1** The Government is grateful to the following respondents for their contribution to the consultation process.

Associated Chemists (Whicker) Ltd.

Aquascot

Arup

Bates Wells Braithwaite

Baxendale

Beakbane

Boydell and Brewer Group

Business Succession

Cambridge Nutritional Foods Ltd

Chartered Institute of Taxation

Childbase

Co-operative Development Scotland

Co-operatives UK

Co-ownership Solutions plc

Deloitte

Eaga Trust

Employee Ownership Association

Ernst and Young

Esop Centre Ltd

Field Fisher Waterhouse

Grant Thornton

Gripple Ltd

Handelsbanken

Horizon Co-Invest

Institute of Chartered Accountants England and Wales

John Lewis Partnership

Law Society Tax Law Committee  
Low Income Tax Reform Group  
Make  
Mooncup Ltd  
Mary Knowles Home Care Partnership Ltd  
Network ROI  
Office of Public Management  
Parfetts  
Parisi Tax  
PB Design  
Perkins Slade  
Pett, Franklin and Co. LLP  
Price Waterhouse Coopers  
Prospects Services  
Postlethwaite Solicitors  
Quintessa Ltd  
RM2 Partnership  
ROI Network  
School Trends  
Scitech Engineering Ltd  
Scott and Fyfe Ltd  
Scott Bader  
Shakespeares Solicitors  
Share Centre  
Share Plan Lawyers  
Skye Instruments Ltd  
Squire Sanders  
SustainAbility Ltd  
Tibbalds Planning and Urban Design Ltd  
Triton  
Tullis Russell  
Wales Co-operative Centre

Welsh Government

Wheatcroft, David (trustee of Sunderland Home Care Associates)

White Rose Employee Ownership Centre

Worker Ownership Options

Wise Investment

Wrigleys Solicitors

Yorkshire Building Society





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