

Employee Share Trust – introduction to tax issues

Purpose of this guidance

The Department of Business, Information and Skills has published a model trust deed – known as an "Employee Share Trust" (EST) – for use by businesses wishing to introduce a trust-based form of employee ownership.

This introductory tax guide is intended for businesses which are looking at employee ownership for the first time, rather than for professional advisers. It introduces the main tax issues associated with using the EST and explains where you can find more detailed guidance published by HM Revenue and Customs.

You may also want to seek advice specific to your business from a qualified legal or tax adviser.

Employee Ownership via trust – general

In general, a company owned wholly or partly by a trust, such as an EST, is taxed in the same way as other companies. For example, its profits are chargeable to Corporation Tax in the same way as other companies, etc.

However, there are a number of special tax rules which apply when assets are transferred into trust when certain actions are taken by, or in relation to, a trust.

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Capital Gains Tax

Introduction

If an individual, or a company, or a body of trustees disposes of shares or other assets then a chargeable gain may arise. There is general guidance on this in HMRC's helpsheet *HS295 – Relief for gifts and similar transactions*:

<http://www.hmrc.gov.uk/helpsheets/hs295.pdf>

This is a brief guide to the tax consequences of disposals made to or by the trustees of an EST. Further guidance can be found in the Capital Gains Manual at:

<http://www.hmrc.gov.uk/manuals/cgmanual/Index.htm>

Please note that most reliefs from capital gains tax are not given automatically: they must be claimed, usually on the tax return submitted to HMRC by the person (including the Trustees) who made the disposal.

The capital gains tax consequences of a disposal depend on:

- The person making the disposal (ie whether they are an individual, a body of trustees, etc.);
- The terms of the disposal (eg gift, sale for full market value, sale other than under a bargain at arm's length); and
- The terms of the trust to which the shares are being transferred.

The following reliefs may be available to or in connection with the EST.

Sales of shares by an existing individual shareholder to the trust

A chargeable gain or allowable loss will normally accrue to the individual. If the sale is not a bargain at arm's length - for instance if the seller voluntarily accepts less than the true value of the shares - the gain will be computed by reference to the market value of the shares rather than the actual consideration received. Relief ('gift hold-over relief') may be available if the shares are in the individual's personal company¹. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG66910.htm>

Sales of shares by an existing corporate or trustee shareholder to the trust

A corporate seller - but not a trustee - may qualify for the 'substantial shareholdings exemption' if they and the company whose shares it has sold meet certain conditions. Where those conditions are met, any gain will not be chargeable. Further details about the substantial shareholdings exemption can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG53005.htm>

If the seller is a close company² then the company will have no chargeable gain but there may be consequences for its shareholders (see below).

If the seller is a company other than a close company then the same relief may be available, but the sale would have to be other than by way of a bargain at arm's

¹ An individual's personal company is one in which he or she can exercise at least 5% of the voting rights.

² A close company is broadly one which is under the control of five or fewer participators, or of participators who are directors. For more detailed guidance see HMRC's Company Taxation Manual at paragraph CTM60060: <http://www.hmrc.gov.uk/manuals/ctmanual/CTM60060.htm>.

length and the EST would have to satisfy further conditions. Further details can be found at: <http://www.hmrc.gov.uk/manuals/cgmanual/CG36040.htm>

If the seller is a trustee and the sale is not under a bargain at arm's length then subject to certain conditions being met gift hold-over relief may be available. Where relief is due, the trustees' gain is reduced, in some circumstances to zero. Further details on gift hold-over relief can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG66910.htm>

If the seller is a trustee and the sale is at arm's length then if gift hold-over relief is not available an alternative hold-over relief may be available if the receiving trust meets certain further conditions beyond those in the model deed. Further details can be found at: <http://www.hmrc.gov.uk/manuals/cgmanual/CG67040.htm>

If no relief or exemption is available then a chargeable gain or allowable loss will arise on the sale. If the sale is otherwise than by way of a bargain at arm's length the gain will be computed by reference to the market value of the shares sold rather than the actual consideration received.

Gifts of shares by an existing shareholder to the trust

A 'gift' means that the donor receives no consideration (payment) for the shares.

As a gift is a disposal otherwise than by way of a bargain at arm's length, the gain or loss is calculated using the market value of the shares as the consideration received. However, the gain may be relieved in some circumstances.

If the donor is an individual and the shares are in the individual's personal company then gift hold-over relief may be due. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG66910.htm>

If the donor is an individual and gift hold-over relief is not due then, providing the EST meets certain further conditions, one of the other reliefs described under "Sales of shares by an existing individual shareholder to the trust" above may be available.

Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG36000.htm>

<http://www.hmrc.gov.uk/manuals/cgmanual/CG67040.htm>

If the donor is a 'close company' then the company will have no chargeable gain but there may be consequences for its shareholders (see below).

If the donor is a company other than a close company then relief may be available, but the EST will have to satisfy further conditions. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG36040.htm>

Alternatively, a corporate donor may benefit from the substantial shareholdings exemption, in which case any gain will not be chargeable. Further details can be found at: <http://www.hmrc.gov.uk/manuals/cgmanual/CG53005.htm>

If the donor is a trustee then, subject to certain conditions being met, gift hold-over relief may be available. Where relief is due, the trustees' gain is reduced to zero.

Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG66910.htm>

If the donor is a trustee then if the EST meets certain additional conditions a different hold-over relief may be available. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG67040.htm>

Sales or gifts of shares by a company out of treasury to the trust

A company may hold its own shares in treasury. A disposal of shares out of treasury is treated as an issue of new shares, and an issue of new shares is not a disposal of an asset by the issuing company. Payment made by the recipient of the shares is treated as an amount subscribed for the shares. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG50209.htm>

Special considerations which apply to close companies and their participators

A close company³ which sells or gifts shares to the EST will generally be treated as having no gain or loss (see above). If the disposal is both by way of a bargain not at arm's length and for less than the market value of the shares, then the difference between the actual consideration received by the company and the market value of the shares or their cost (whichever is the less) is apportioned amongst the shares of the company and serves to increase the gain (or reduce the loss) of the shareholder when those shares are later disposed of. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG57122.htm>

Relief for trustees of the trust on gifts of shares to a share incentive plan

If the trustees of the EST transfer shares to a share incentive plan (if one exists) as a gift then, subject to certain conditions, gift holdover relief may be available. Where

³ See previous footnote

relief applies, the trustees' gain is reduced to zero. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG66910.htm>

Relief for trustees of the trust on sale of shares to a share incentive plan

The trustees of the EST may sell shares to a share incentive plan (if one exists) for payment equal to or less than their market value. If the trustees reinvest the proceeds of the sale then, subject to certain conditions, they may be able to claim relief so that no gain and no loss accrues on the sale. Further details on this relief and the associated conditions can be found at:

<http://www.hmrc.gov.uk/manuals/cgmanual/CG61970.htm>

Tax treatment of disposals of shares to employees or other principal beneficiaries by trustees

When the trustees of the EST sell or give shares to employees or other beneficiaries they will make a disposal for capital gains tax purposes. A chargeable gain or allowable loss will accrue to the trustees. Although a limited number of reliefs may be available to reduce any gain, the trustees may be liable to pay capital gains tax and will have to notify HMRC and make a return and self-assessment of their liability.

If the disposal is otherwise than by way of a bargain at arm's length, the gain or loss will be computed by substituting the market value of the shares for the actual consideration received (if any).

Possible future developments

At Budget 2013 the Chancellor announced that the government planned to introduce a new capital gains tax relief for individuals who sell a controlling interest in a business to an employee-owned structure. There will be a consultation on this proposed relief during 2013 with a view to introducing for disposals on or after 6 April 2014.

Inheritance Tax

Inheritance tax is charged on a 'transfer of value' which is broadly a transfer or disposal of cash or other property which reduces a person's estate. It is also charged on property held in trust every ten years, or when property leaves the trust.

Transfers of cash or shares to an EST by a close company

A transfer of cash or shares by a close company which gives rise to a transfer of value to a trust which is for the benefit of all or most of the employees of a company

under the terms of the EST will not be a chargeable transfer of value for inheritance tax. <http://www.hmrc.gov.uk/manuals/ihtmanual/IHTM42956.htm>

But this does not apply where a trust allows any employee who is also a participator⁴ in the company or his family/dependants to benefit from the trust, unless the only way they can benefit is as described in paragraph 1.6 of the Notes to the EST. Further details can be found at: <http://www.hmrc.gov.uk/manuals/ihtmanual/IHTM42962.htm>

Transfers of cash or shares in a close company to an EST by a shareholder or participator

A transfer of value by an individual of his shares in a company to an EST will not be a chargeable transfer, provided the trustees hold more than half the shares in the company within one year of the transfer and have powers of voting on all questions affecting the company as a whole.

But this does not apply where the trust permits a participator, former participator, any other settlor who is a participator in another company, or anyone connected to them, to benefit from the trust unless the only way they can benefit is as described in paragraph 1.6 of the Notes to the EST. Further details can be found at: <http://www.hmrc.gov.uk/manuals/ihtmanual/IHTM42950.htm>

Transfers of value by a public limited company

If a public limited company that is not a close company makes a transfer to an EST there is no chargeable transfer for inheritance tax, but the trust will be subject to the settled property rules set out below. Further details can be found at: <http://www.hmrc.gov.uk/manuals/ihtmanual/IHTM42953.htm>

Inheritance tax treatment of an EST

A trust set up under the EST rules will satisfy the main conditions which require that the trust is for the benefit of all or most of the employees of a company. The trust will not be a 'relevant property' trust⁵ and will be exempt from the normal charges that will apply on payments into or out of the trust, or on the ten year anniversaries of the trust being set up. Further details can be found at: <http://www.hmrc.gov.uk/manuals/ihtmanual/IHTM42945.htm>

⁴ A participator of a company is broadly any person who has a share or interest in the capital or income of the company.

⁵ Relevant property trusts are most types of discretionary trusts

Where shares or securities held by the trustees of a 'relevant property' trust cease to be relevant property and are then held on trusts that meet the terms as set out under the EST rules, there will be no charge provided the exceptions that apply are met. If these conditions are not satisfied there will be an IHT charge when property ceases to be relevant property. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/ihmanual/IHTM42948.htm>

Property leaving an EST

Where property leaves an EST, no charge will arise if the transfers are a payment out of settled property, or payments which would be regarded as income for income tax purposes. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/ihmanual/IHTM42982.htm>

<http://www.hmrc.gov.uk/manuals/ihmanual/IHTM42986.htm>

Where property leaves an EST and no longer satisfies the main conditions a charge to inheritance tax will arise on the settled property leaving the trust:

- on sub trusts or funds which are set up for a specified class of employees if they are not for the benefit of all or most of the employees;
- where a payment or non-commercial loan is made to a settlor, participator or any person connected with them;
- where the trustees make a transfer which reduces the value of the settled property.

Further details can be found at:

<http://www.hmrc.gov.uk/manuals/ihmanual/IHTM42981.htm>

Business property relief

This relief may be available on chargeable transfers into and out of an EST if the conditions for the relief are satisfied. Further details can be found at:

<http://www.hmrc.gov.uk/manuals/ihmanual/IHTM42965.htm>

Income Tax

Tax on trust income

Guidance on types of trust income and the rates of tax which apply can be found at:

<http://www.hmrc.gov.uk/trusts/income-tax/income-types.htm>

Income tax charges arising from actions of the Trustee

Certain actions by the Trustee could result in an amount counting as employment income of one or more of the employees of the Company, even though no payment may be made to them.

Paragraph 7.1 of the Trust Deed refers to this. While that paragraph gives the Trustee various powers to provide benefits to Principal Beneficiaries, it also obliges the Trustee to obtain the approval of the Directors (of the Company) in writing before it exercises any of its powers in a way which would (or might reasonably be expected to) give rise to a charge to income tax under Part 7A of the Income Tax (Earnings and Pensions) Act 2003 (“ITEPA”). HMRC’s detailed guidance on this legislation is available in the Employment Income Manual:

<http://www.hmrc.gov.uk/manuals/eimanual/EIM45000.htm>

This legislation deals with income tax on employment income provided through third parties and it is relevant to the Company, the Principal Beneficiaries and the Trustee. In general, it tackles arrangements which:

- involve third parties (including trusts or other vehicles used to reward employees, such as share schemes), and
- seek to avoid or defer the payment of income tax.

Broadly speaking, if arrangements of the Trustee are used to provide for what is in substance a reward or recognition, or a loan, in connection with the employee’s current, former, or future employment, then an income tax charge arises.

There are also detailed exclusions to prevent the legislation from catching certain arrangements. Generally, the exclusions are targeted at arrangements which are not tax avoidance arrangements. If an exclusion applies, there will be no immediate charge under the legislation – although, in certain circumstances, a charge may apply at a later date if the conditions for exclusion fail to be met.

As noted above if the legislation applies, it deems an amount to count as employment income which is specifically brought within the scope of PAYE.

Generally speaking, the amount counting as employment income for income tax purposes also attracts Class 1 national insurance contributions (NIC).

To the extent that an amount counts as general earnings for income tax purposes, Part 7A income is reduced (though not beyond nil). In other words, the general earnings charge takes priority over Part 7A of ITEPA.

HMRC’s guidance on NIC in this area can be found at:

<http://www.hmrc.gov.uk/employers/nic-faqs.pdf>