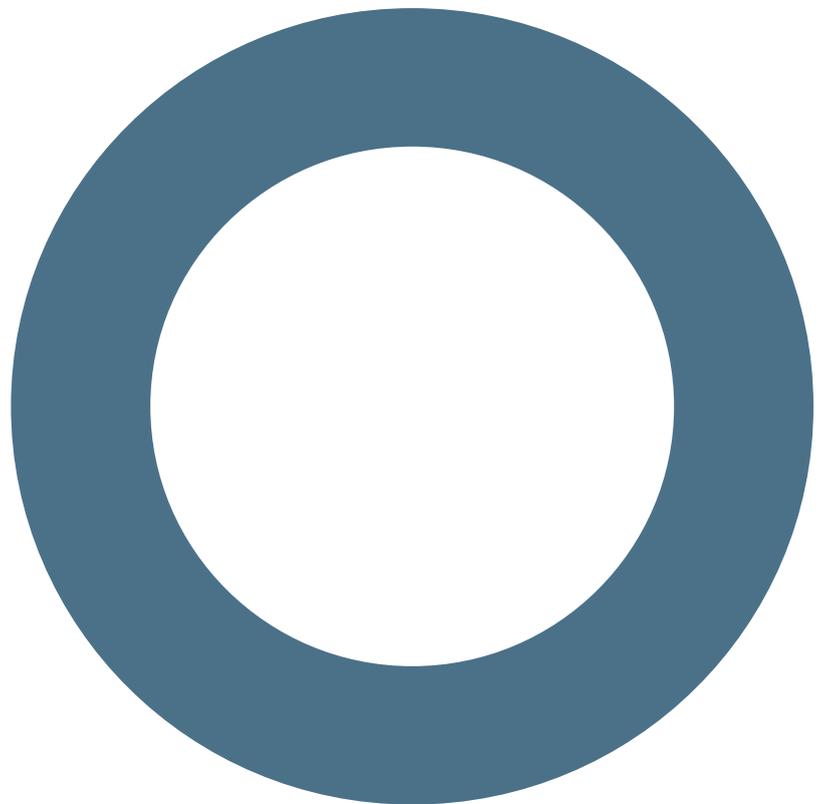




GUIDE TO STRUCTURING EMPLOYEE OWNERSHIP



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PUBLISHED BY:

 **EOA** EMPLOYEE
OWNERSHIP
ASSOCIATION
BETTER BUSINESS TOGETHER

IN ASSOCIATION WITH:

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development
scotland

 **Law Society
of Scotland**

Guide to Structuring Employee Ownership

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FOREWORD



BETTER BUSINESS TOGETHER

If you are exploring employee ownership and are ready to consider the detail of implementation, this guide is for you.

We thank Robert Postlethwaite for authoring this Guide, which is an invaluable tool for navigating through the transition process, and to his firm, Postlethwaite for its sponsorship of its production.

Evidence in the Ownership Dividend report cites employee owned businesses as:

- Having more engaged employees – via more inclusive, transparent and effective models of corporate governance and employee

engagement which better motivate and financially reward individuals through their ownership stake.

- Having improved productivity - businesses unlocking the enhanced performance and productivity powered by the increased personal endeavour of employees acting with greater common purpose once they become employee owners.
- Contributing to Resilient regional economies – via a more sustainable and resilient business model that root jobs locally by providing an effective business succession solution, business independence and the ability to plan growth and investment over the longer term.

The EOA is a network of 360+ businesses that connect to network, learn and share best practice, on employee ownership – we would

love to welcome you as a member to support you on your journey to employee ownership.

I wish you and your future owners an engaging and productive future,

Deb Oxley OBE
Chief Executive
Employee Ownership Association

co+operative development scotland

Co-operative Development Scotland is delighted to be working in partnership with the Law Society of Scotland and the EOA on this Guide.

We are the arm of Scotland's enterprise agencies that supports company growth through collaborative and employee ownership business models.

If you operate in Scotland and are looking for specialist employee ownership support, we would love to hear from you.

The number of employee-owned businesses operating in Scotland has trebled over the past five years and is expected to grow at an accelerated rate in the future. The fast-growing popularity of employee ownership, and increasing demand for expert advice on it, means this Guide will be an invaluable tool - not only for business owners, but also for legal, accounting and banking professionals.

Increasing the number of firms that are able to offer in-depth specialist guidance on employee ownership will greatly benefit businesses in Scotland and throughout the UK, supporting economic development across the country.

Sarah Deas
Director
Co-operative Development Scotland

1. INTRODUCTION AND DIFFERENT FORMS OF EMPLOYEE OWNERSHIP

New to employee ownership?

If you are new to employee ownership and are not sure what it involves or what it looks like, we suggest that you take a look at our separate guide Employee Ownership: How To Get Started. You can download here: <http://employeeownership.co.uk/wp-content/uploads/The-How-to-Guide.pdf>

Forms of employee ownership

As the How to Get Started guide describes, employee ownership can take three main forms:

- **Direct (individual) share ownership**
Each employee becomes a shareholder, personally holding a specified number of shares.
- **Indirect ownership**
Shares are held on behalf of employees as a whole in an employee trust, which must manage the shares in the best interests of the employees, in accordance with the terms of the trust deed and the law. A trust is a legal arrangement under which assets are held by one person or a group of people (the trustee or trustees) but they are not permitted to derive any personal benefit from them; instead, the assets must be held for the benefit of individuals (beneficiaries). In an employee trust, the beneficiaries are a business's employees.
- **Hybrid ownership**
This combines ownership of a strategic block of shares in an employee trust with individual share ownership.

The potential benefits of direct individual share ownership are clear: every shareholder may receive a regular profit share through dividends, have voting rights and the possibility of selling their shares at a profit if they grow in value.

The benefits of indirect employee ownership include this being a simpler model to operate. It is often chosen by businesses intending that trust ownership will benefit employees over the long term through the trust influencing the company's direction, the employees frequently receiving a direct profit share from the company.

A trust's holding of a particular percentage of a company will often be accompanied by an arrangement that the same percentage of the company's annual profits will be passed by the company directly to employees. If the trust owns more than 50% of the company's shares, it may be possible for bonuses to a certain value to be paid income tax free.

Where the majority of a company's shares are held by a particular form of employee trust, an employee ownership trust – two additional statutory tax reliefs are available:

If the trust's ownership comes about through it buying shares from existing shareholders, they are exempt from CGT if the trust acquires more than 50% of the total shares.

Employees of a company which is more than 50% owned by an employee ownership trust can be paid income tax free bonuses of up to £3,600 each per year.

1. INTRODUCTION AND DIFFERENT FORMS OF EMPLOYEE OWNERSHIP

Which suits your company

Generally, trust ownership will be simpler both to set up and run. But this does not make it an automatic best choice for all companies, some of which may feel that individual ownership is better suited to their circumstances. In the following table we set out each of the three forms of employee ownership and a range of different circumstances and objectives which, depending on to what extent they are present in your company, may help you consider which might work best in your company.

Individual share ownership	Indirect (trust) ownership	Hybrid ownership
<p>Capital growth important</p> <p>Low staff turnover</p> <p>Smaller employee numbers</p> <p>Employees likely to consider personal share ownership more real than trust ownership</p> <p>Tax breaks for individual share ownership make it more attractive and affordable</p> <p>Important that employees make a personal financial investment</p>	<p>Higher staff turnover</p> <p>Larger employee numbers</p> <p>Long term investment/ownership is important</p> <p>Desire to prevent (or make difficult) a takeover</p> <p>Employees may have difficulty funding share acquisition</p> <p>Limited funds to buy back employees' shares</p> <p>If bonuses/performance based rewards are important, the company is happy for these to be cash-based rather than involving shares.</p> <p>Under ownership by an employee ownership trust (EOT), the ability to pay bonuses free of income tax is important.</p>	<p>Trust ownership is preferred but you want some individual share ownership to provide:</p> <ul style="list-style-type: none"> - a modest degree of capital growth <p>and/or</p> <ul style="list-style-type: none"> - a direct feeling of ownership <p>You want to limit the total number of shares in circulation, as this limits any need for the company to help pay for share buybacks from employees who wish to sell their shares (or are required to because they leave)</p>

2. WHEN AND HOW TO DO IT

When

Employee ownership can be created either at the foundation of a business, or when it is already established.

Creating employee ownership as part of a new business will generally be simpler than doing so when the business is more established and has acquired value. Traditionally, new businesses tend to start off as a single individual, or as a joint initiative of a small group of entrepreneurs, sometimes with outside investors, who are all more or less involved in the management and/or financing of the venture. However, it is increasingly common for new ventures to set aside a pool of shares to be allocated to employees for individual share ownership. Where employee ownership can be brought into being in a business's early years this will often avoid tax complications for employees and current shareholders, because share value is likely to be relatively low.

However, many companies that create employee ownership will do so later in time. This may be because they only feel it necessary to do so once their business has become established, or when the original founders wish to sell their stake (or a major part of it), and sale into employee ownership is seen to be the most desirable route.

There will be more to think about when selling shares in an established business into employee ownership. In addition to considering what form employee ownership will take, the current owners will also have to make decisions about how much of the company will be employee owned, what the price will be, how the transaction will be financed and their own tax situation. It will also be important to gain the support of all current shareholders for the proposals.

Employee ownership may also be created where a new business is formed to take over responsibility for delivering a public service (often called an **employee-led/owned public service spin out**). Here, many of the same issues will arise as where employee ownership is to be built into any other new business. Additionally, there are likely to be legal and practical tasks associated with transferring responsibility for service delivery to the new company.

How

The first decision will be on whether you want individual, trust or the hybrid form of employee ownership. What happens next is going to depend on which you have chosen.

Individual ownership

If your goal is ownership succession (not simply creating a pool of shares for your employees without you giving up control or selling a significant part of your ownership), it is unlikely that your company's ownership will move straight to individual ownership.

Instead, it is more likely that you will first transfer some or all of your shares to a trust. If you then want your employees to acquire shares personally, a second step will be for the trust to transfer some of its shares to employees.

However, if you do not intend giving up control and your wish is to allow employees to join you as shareholders, you will want to consider how you may best do this.

So if your goal is one of the above, at the appropriate time you will need to think about how employees are going to acquire their shares. There are three main ways of doing so. Employees can, in the main:

- be given shares
- buy shares
- be granted options to acquire shares in the future

2. WHEN AND HOW TO DO IT

Where employees are given **free shares**, they will be subject to income tax (and possibly also National Insurance) on the value of the shares when they receive them, unless they do through a tax exempt arrangement. In a company's early months of trading, its shares may have only a low value and so there may be no or minimal taxation consequences. However, shares in a more established company are more likely to have acquired a financial value, in which case you may want to consider how to avoid an award of free shares resulting in a tax liability. You could establish a Share Incentive Plan (**SIP**), which provides statutory tax relief in respect of awards of free shares, subject to several conditions and requirements, including that employee will not generally be able to sell their shares within five years of acquiring them. Alternatively, employees could be granted options to receive their free shares in the future, which will defer the tax liability but may mean – if the shares have grown in value by the time they are actually acquired – that the liability increases (please see further later in this section).

If employees **buy shares**, this will not create a tax liability (so long as the price they pay is at least market value) but they will of course need to find the money to pay for them. It is often possible for them to pay by instalments, although if they do not pay interest on the outstanding amount they will generally have to pay income tax and NI on the unpaid interest. A second way in which a SIP can be used is to allow

employees to purchase shares by deduction from their pre-tax weekly or monthly pay, giving them full relief against income tax and NI on the purchase price. Where employees are granted **options** to acquire shares in the future, this will not create an immediate tax liability. However, when the employee buys their shares (by exercising their option) they will have to pay income tax and possibly NI on the difference between the amount they pay and the shares' value at the time the option is exercised, unless an exemption is available. Exemptions can be obtained by granting Save As You Earn (**SAYE**) options, Company Share Option Plan (**CSOP**) options or Enterprise Management Incentive (**EMI**) options, each of which provide that the taxation then becomes capital gains tax (**CGT**) instead, and so is due at a significantly lower rate and only when the shares are eventually sold. They are each described in more detail in section 4 and in the Schedule.

You will also need to consider longer term conditions of ownership. For example, what happens if an employee wishes to sell their shares or leaves? It is common to provide in the company's articles of association that employees wishing to sell must offer their shares internally, and that if they leave they must offer them for sale. By making a trust (or possibly the company itself) the first eligible buyer from employees, the potentially complex task of matching multiple sellers to multiple buyers can be avoided.

Disposals of shares by employees at a higher value than when the shares were acquired may be subject to **CGT**.

Once you have decided how employees are to acquire shares, you can move to implementation. As well as making any necessary changes to your company's articles of association to accommodate employee shareholders, this will include supplying employees with information about their opportunity to become shareholders and what they must do if they wish to take up that opportunity. If you have decided to use a tax-advantaged employee share ownership plan, this will need to be established and registered with HM Revenue and Customs, and share value will need to be agreed with HM Revenue and Customs (this is because the tax reliefs provide (in relation to options) for low tax growth in share value after option grants and (in relation to both the option plans and the SIP) are subject to financial limits based on share value).

2. WHEN AND HOW TO DO IT

Trust ownership

If your goal is ownership succession, it is most likely that you will need to establish an employee trust. Alternatively, if you are setting up a new employee owned company which you want to be owned indirectly or under the hybrid approach referred to earlier, you will need to create an employee trust.

To do this, it will be necessary to prepare a trust deed which will be formal evidence of the trust's creation and will set out its terms. These terms may include how the individuals responsible for running the trust (trustees) are to be appointed, any particular constraints on what the trust may do with its shares and, if the trust is to be an employee ownership trust conferring relief against CGT on those who sell to it and/or enabling employee to receive bonuses free of income tax, specific provisions required by the tax legislation.

The trust will then acquire the shares that are to become employee owned, which it may do either by subscribing for new shares (if existing shareholders are not retiring from the ownership) or by purchasing them from existing shareholders (if they are).

Hybrid ownership

Here you will need to consider all the issues referred to above.

The trust will then transfer some of its shares to employees (either by sale, gift or grant then eventual exercise of options), normally over a period of several years. It will retain a specified number of shares on a long term basis. For example, where a trust has acquired all the shares in a company it may always ensure that it retains more than 50%, so that it maintains ownership control of the company.

If it is an employee ownership trust, availability of the two tax reliefs is conditional on it doing so.

Other issues

Whichever form of employee ownership you choose, you may need the approval of your company's shareholders to put it all into effect. For example, shareholder approval is often needed where a company is to create new shares and always needed for change to a company's articles of association.

Employee ownership using existing shares

If you are establishing employee ownership without your company's existing shareholders retiring as owners, the main steps will be those summarised earlier in this **How section**.

However, there will be some more things to think about if employee ownership is part of an ownership

succession plan.

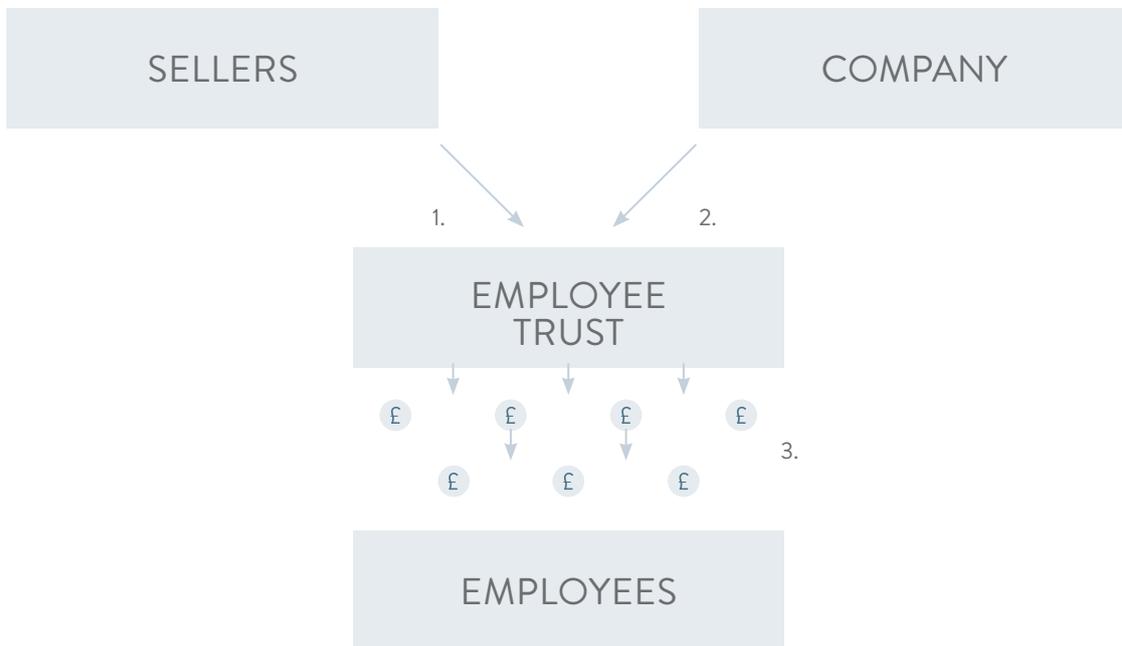
Whether the intention is to have individual, trust or hybrid employee ownership, it is likely that an employee trust will need to be established as a single buyer from the selling shareholders. It is complex to transfer what may be a significant holding of shares from existing shareholders to multiple employees in a single transaction but far easier to transfer them to a single body – the trust – which can then either retain them or transfer them to employees over a future period. Once the trust has completed its share purchase, it will then either retain the shares (**trust ownership**), distribute some of them (**hybrid**) or distribute all of them (**individual ownership**). Even under individual ownership, it may still be advisable to retain the trust after it has distributed all its shares to employees, as it can then buy shares back from employees who subsequently wish to sell (or are obliged to because they leave) and then recycle them.

Three illustrations follow showing how shares may be purchased from current shareholders by an employee trust.

2. WHEN AND HOW TO DO IT

Overview of possible purchase structure: trust ownership

This diagram illustrates how ownership may be transferred from existing shareholders to an employee trust

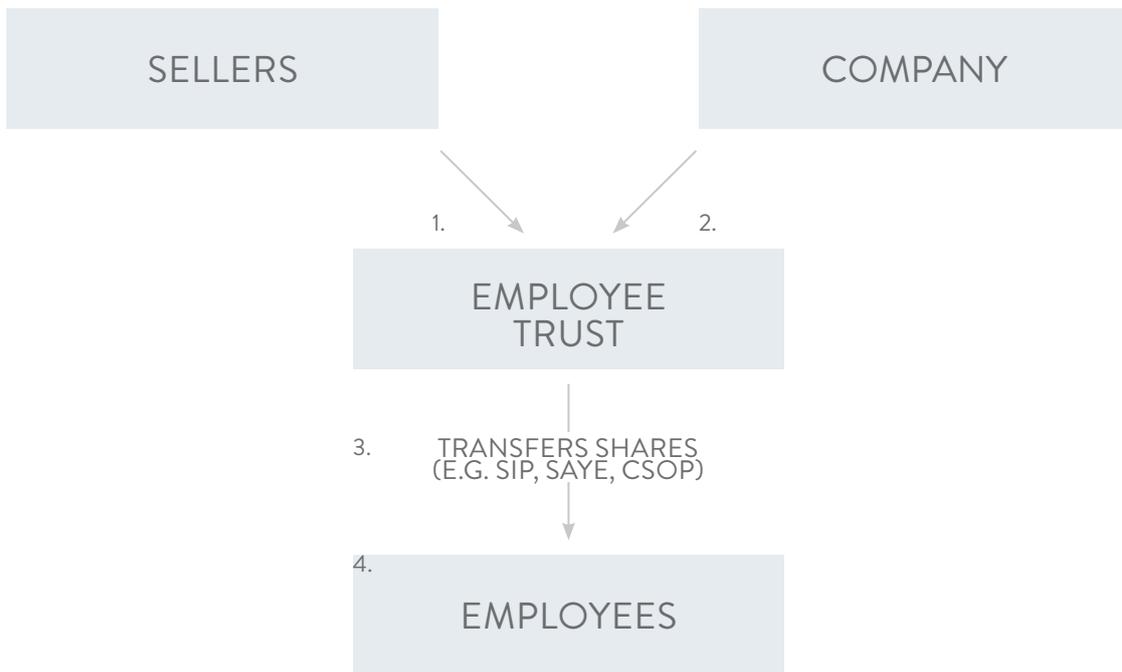


Steps:

1. Sellers transfer shares to trust (can be employee ownership trust or more generic form of employee trust)
2. Company profits are paid to trust and then used to finance payments to sellers (this may be over a period of time after the trust's purchase, so the sellers are not paid in full immediately)
3. Trust holds shares for the benefit of employees.

2. WHEN AND HOW TO DO IT

Overview of possible purchase structure: individual ownership



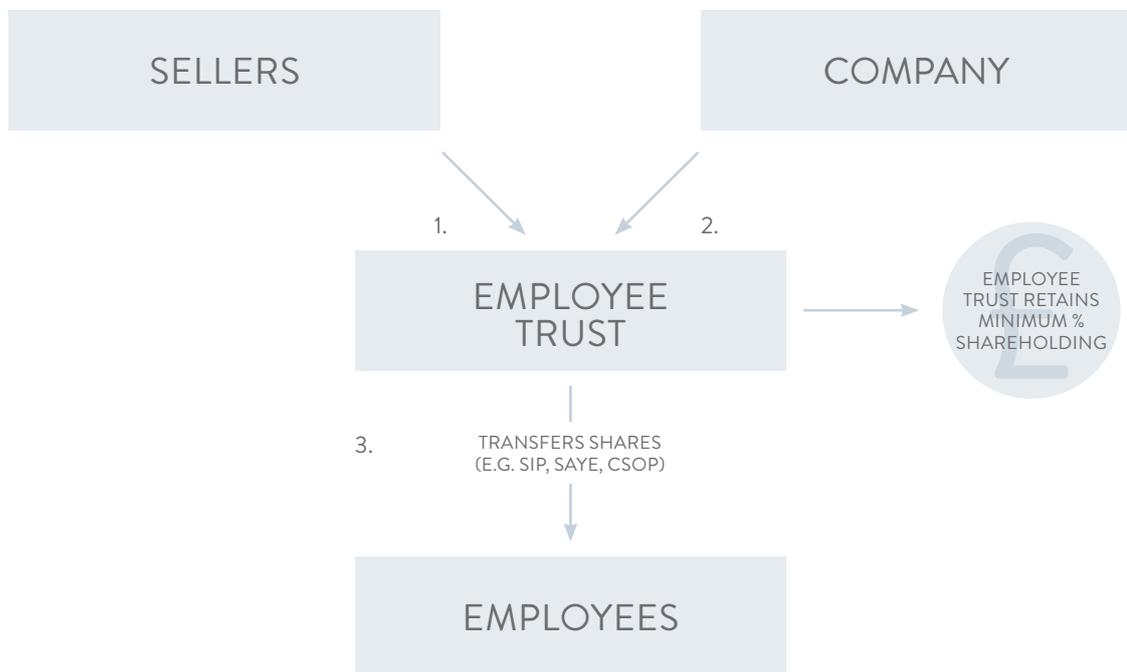
Steps:

1. Sellers transfer shares to trust
2. Company profits are paid to trust and then used to finance payments to sellers (this may be over a period of time after the trust's purchase, so the sellers are not paid in full immediately)
3. Trust transfers shares to employees. If employees pay the trust for their shares, this may be an additional source of funds for paying the sellers
4. Eventually, employees hold all the shares and the trusts holds none (or possibly only shares which it acquires from employees who leave or wish to sell, intending to pass them on to other employees)

2. WHEN AND HOW TO DO IT

Overview of possible purchase structure: hybrid ownership

This is variation of the first diagram, showing individual share ownership as an additional element:



Steps:

1. Sellers transfer shares to trust.
2. Company profits are paid to trust and then used to finance payments to sellers (this may be over a period of time after the trust's purchase, so the sellers are not paid in full immediately). If employees pay the trust for their shares, this may be an additional source of funds for paying the sellers.
3. Trust transfers shares to employees but always retains a minimum percentage shareholding.

2. WHEN AND HOW TO DO IT

Overview of possible purchase structure:

Before putting such an arrangement in place, these additional questions will need to be considered:

- What percentage of the Company's shares is to be sold?
 - How many shares is the trust to buy?
 - What is their value and, if different, for what price are the current shareholders willing to sell?
 - How will the shares be paid for?
 - If the Company is to fund the trust to buy the shares, how long will it take?
- Are the current shareholders willing to wait to be paid for their shares?
 - If not, might it be possible for the trust to borrow the purchase price from a bank or other lender, repaying its loan from future contributions by the Company?
 - What will be the taxation treatment for the sellers?

It is not possible to answer these questions in this guide, although we can provide a summary of the taxation rules. Please see Section 4.

3. DO'S AND DON'T'S OF EMPLOYEE OWNERSHIP

Do:

- Look at some other companies that have introduced employee ownership, what approach they have taken and why. Consider any lessons from their experience for your own company
- Review carefully which form of employee ownership – trust, individual or hybrid – will work best in your own company taking into account its own circumstances
- Think carefully about the scheme's intended long term purpose. For instance, if a trust is to retain a minimum number of shares, consider making this a condition in the trust deed. Equally, if you favour direct individual share ownership but staff are unlikely to have sufficient spare funds to purchase shares at market value, consider gifting shares instead.
- If direct ownership is intended,
 - Consider how the internal market for shares will work, and whether the market will be supported by funding from the company
 - Consider putting in place/ retaining some long term trust ownership, to relieve pressure on the internal market and to reduce the number of shares in circulation.

- Always consider the tax ramifications – ensuring that tax considerations do not interfere with the primary purposes of the plan.
- Ensure that ongoing record keeping systems and procedures are effective and robust.
- Make it a top priority to communicate regularly with employee shareholders about the company's financial performance.
- Ensure that you have a capable, committed and motivated management team moving forward, and that you find the right balance between them being accountable to the company's owners and having the scope to do their job.
- Put in place clear reporting lines between management and shareholders, and ensure that shareholders are engaged.
- Consider training for trustees if you have an employee trust.
- Ensure special incentives for senior management are independently approved. Consider setting up an independent remuneration committee.

Don't:

- Appoint trustees exclusively from the board of directors. This is likely to create conflicts of interest, which could result in personal liability for the director/trustee. Instead, consider appointing employees (perhaps selected by election from amongst the employees) and perhaps an independent person. In any case, directors of the company should be a minority of the trustees at most, and ideally no-one who is a director of the company should also be a trustee.
- Try to hide bad news. Employees in an employee owned company should be treated in the same way as any other shareholder. They should be notified of bad performance promptly, as well as of what measures are being taken to remedy the situation.
- Make arrangements too complex. Complexity tends to confuse – this will mean that employees may not fully understand the benefits of the scheme, and also increases the risk of unforeseen consequences.
- Let tax considerations dictate the structure of your scheme, except to the extent that they are consistent with your primary aims.

4. TAXATION

It is very unlikely that you will be able to create employee ownership in your company without thinking about taxation, as there can be implications for employees, employee trusts, the company itself and any existing shareholders who are selling their shares. However, there are also a number of tax reliefs whose purpose is to foster employee ownership. Tax issues should not generally be an impediment to employee ownership, and in many instances the effect of the reliefs may be to increase its attractions.

Employees

Tax issues will generally only arise for your company's employees if it introduces direct individual employee share ownership or the hybrid form combining trust and individual share ownership.

If your company has only trust ownership, there will not normally be any tax issues for employees, with two possible exceptions.

First, if the company or the trust pays cash bonuses, these will be subject to income tax and NI as part of employee pay. However, where the company is controlled by an employee ownership trust that meets certain conditions (see the Schedule), a tax relief available where a company is owned by a statutory employee ownership trust allows it to pay annual bonuses of up to £3,600 per person income tax free (but still subject to NI).

Second, if the trust reserves or earmarks any of its assets (cash, shares or other assets) for particular employees, they may be liable for income tax and NI on their value when this happens, even if they do not immediately receive them.

If you create individual or hybrid ownership, the acquisition by employees of shares (and their disposal) may result in a personal tax liability where the employee acquires shares for less than their market value. Additionally, if the employee subsequently disposes of their shares for more than their value when they were acquired, they will often be subject to CGT on the gain.

The statutory tax reliefs described in the following table are available to ease the tax burden for employees who acquire shares directly;

4. TAXATION

	Income tax and NI treatment	CGT treatment	For which employees?	Other comments
Share Incentive Plan (SIP)	<p>Enables employees to:</p> <ul style="list-style-type: none"> • Be given free shares, with no income tax or NI on their value • Purchase shares, with full relief against income tax and NI on the purchase price 	No CGT on growth in value	If shares are offered under a SIP, they must be offered to all employees (or all who have completed a minimum period of employment)	Various conditions apply, including that the shares must normally be retained for five years
Save As You Earn (SAYE) share option	<p>Employees are granted an option to acquire shares from a future date (normally three or five years later) at today's value (or today's value less 20%), and must agree to save a monthly amount towards the total option exercise price. At the end of the three/five year period, each employee can decide whether to use their savings to exercise their option or cash in their savings</p>	<p>CGT is due on growth in value, when the shares are eventually sold. Normal rate is 10% or 20% depending on whether the employee is a basic or higher rate taxpayer, subject to annual exemption (£11,700 in 2018-19)</p>	If SAYE options are offered, they must be offered to all employees (or all who have completed a minimum period of employment)	Minimum option period of three years. Other conditions also apply.
EMI options	<p>Selected employees are granted an option to acquire shares from a future date, at the end of which participating employee can decide whether to exercise their option</p>	<p>Same as for SAYE options, save that it will often be possible to apply a 10% rate for gains made on shares acquired through EMI options</p>	<p>Do not have to be offered to all employees and may be targeted at selected employees. May therefore be appropriate where a company wishes to create greater levels of share ownership for key employees</p>	<p>Only for smaller companies and some trades excluded. Other conditions also apply.</p>
Company Share Option Plan (CSOP)	<p>Selected employees are granted an option to acquire shares from a future date (minimum of three years later), at the end of which participating employee can decide whether to exercise their option</p>	<p>Same as for SAYE options</p>	<p>Do not have to be offered to all employees and may be targeted at selected employees. May therefore be appropriate where a company wishes to create greater levels of share ownership for key employees if EMI options are not available</p>	<p>Conditions apply.</p>

4. TAXATION

Employee Trusts

A trust will be subject to income tax on its income. For this reason, where a company is funding a trust it will generally do so by making gifts of money rather than paying dividends on the trust's shares, as HMRC policy is that these are not subject to income tax. It is important to ensure that these payments are made voluntarily and that the company has not entered into a contract with the trust to pay them.

If a trust disposes of shares (or many other types of asset) when their value is greater than at the time it first acquired them, it may be liable to pay CGT on the gain in value. If the trust is an employee ownership trust, it will also then be liable to pay any CGT from which the previous shareholders claimed exemption. If the trust is located offshore, its gains will currently be exempt from CGT.

The trust should also be structured to avoid any inheritance tax liability, either on payments made to it by the company or during the life of the trust or if it transfers shares (or other assets) to employees.

Where the trust (or employees directly) buy shares from existing shareholders, stamp duty will be payable on the purchase price at £5 per £1,000.

The Company

The following tax breaks are available for companies:

- Corporation tax relief on gains made by employees through the exercise of options
- Corporation tax relief on the value of free shares awarded under a SIP (or other free share awards)
- Corporation tax relief on payments made to a SIP which it uses to acquire 10% or more of the company
- No employer's National Insurance on the value of shares awarded under a SIP or on option gains under SAYE, EMI or CSOP options

If a company makes a loan to a trust which holds or acquires shares in the company and the company is a close company (controlled by five or fewer shareholders) then generally the company will be required to deposit 25% of the loan with HM Revenue and Customs, repayable when the loan is repaid.

4. TAXATION

Selling Shareholders

If you are an existing shareholder contemplating a sale of your shares (or some of them) which are then to become employee-owned, you will want to understand the tax impact on you personally.

Normally a sale of shares to a third party would directly result in a seller being subject to CGT. If they are eligible for entrepreneurs' relief, this would be paid at a rate of 10%; if they sell to a statutory employee ownership trust which acquires control of their company, they are entirely exempt from CGT (see below and the Schedule). However, special rules apply where a company's own funds are being used to finance payment of the purchase price, to ensure that the payments to the sellers are not in reality "disguised dividends" which would otherwise be taxed as dividends at a significantly higher rate.

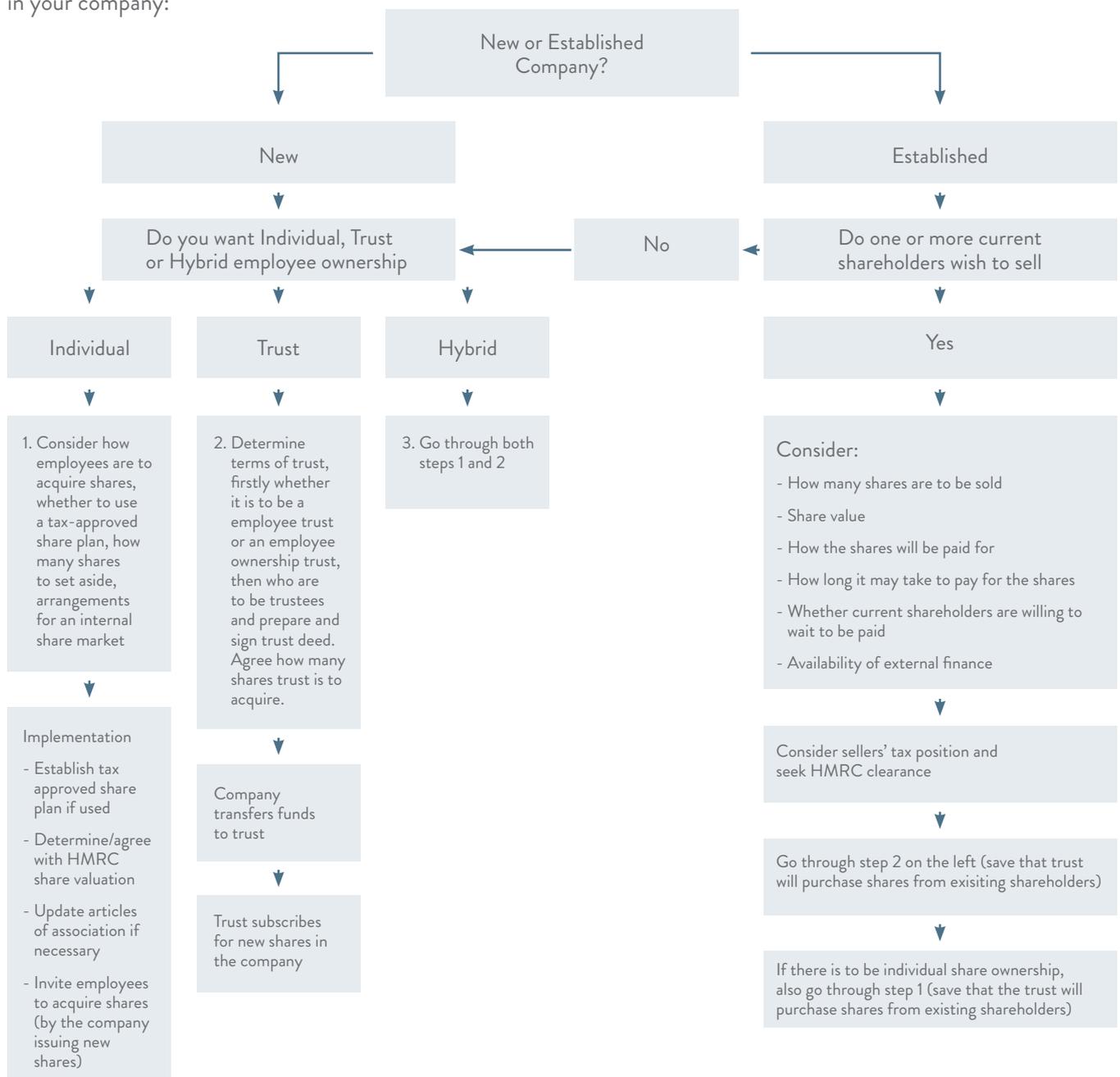
To avoid a situation where these special rules apply and therefore obtain CGT treatment, it is necessary to show that tax avoidance is not a reason for the sale. An advance clearance application can be made to HM Revenue and Customs, in which it will be important to explain why it is in the interests of the company for it to fund an employee trust to purchase shares from its shareholders. In the experience of the writer, if a strong case is made, the trust is to acquire more than 50% of the company's shares and the sellers are not in any other way to have residual control of the company, there is good chance of obtaining clearance. If the trust is to acquire more than 75% of the company on a long term basis, clearance should be granted. If the trust is acquiring less than 50% of the company, it may become harder to obtain clearance. However, each case should always be considered on its own merits.

A shareholder who sells their shares to a statutory employee ownership trust that meets the requirements of the tax relief legislation is entirely exempt from CGT on their capital gains. The Schedule sets out these requirements in more detail, but the main ones are that (i) the trust must acquire more than 50% of the shares in the company and (ii) the trust's terms must stipulate that if it distributes any benefit to employees it does so on the same terms (i.e. either the same amount per employee, or differing amounts depending on salary, hours worked or length of service).

A longer standing, but little used, tax relief allows a shareholder who sells shares to a SIP exemption from CGT, if the SIP acquires at least 10% of the company and the seller reinvests their sale proceeds in other investments. In practice, and perhaps rather perversely, it has proved difficult to obtain HM Revenue and Customs clearance for the seller's sale proceeds to be subject to CGT instead of income tax, because the source of the SIP's funding is likely to be the company's profits.

5. IMPLEMENTATION FLOW CHART

The flowchart which follows summarises the main steps you may need to go through to create employee ownership in your company:



CONCLUSION

Employee ownership is an incredibly effective ownership model that is relatively simple to adopt whilst being very flexible to the individual needs of different businesses.

It offers an excellent succession solution for SMEs and family owned businesses, but is also adopted by businesses as a growth strategy.

Direct, indirect and hybrid models of employee ownership can be seen in a range of highly successful exemplar organisations across the UK.

The popularity of employee ownership – growing at more than 10% a year – is based on the growing evidence [1] of its benefits:

- **More engaged employees** – via more inclusive, transparent and effective models of corporate governance and employee engagement which better involve, motivate and financially reward individuals through their ownership stake.
- **Improved productivity** - businesses unlocking the enhanced performance and productivity powered by the increased personal endeavour and discretionary efforts of employees acting with greater common purpose once they become employee owners.
- **Contribute to resilient regional economies** – via a more sustainable and resilient business model that root jobs locally by providing an effective business succession solution, business independence and the ability to plan growth and investment over the longer term.

How the EOA can help

The next steps must include detailed dialogue with carefully selected existing employee owned organisations and, ultimately, the use of lawyers and accountants to undertake the technical implementation work and taxation planning described in this Guide.

Most organisations that become employee owned are guided and assisted in those key next steps by the Employee Ownership Association (EOA), the publisher of this Guide.

The EOA is both a membership organisation with a network of 360+ businesses. We connect businesses to network, share best practice and learn. As the voice of the £30bn employee ownership sector in the UK we also work with our members to champion employee ownership and influence future policy.

Email: info@employeeownership.co.uk Call: 01482 667122

Support in Scotland

This Guide is intended as a useful tool to help you get started. In terms of the next steps, if you are based in Scotland and would like to learn more about employee ownership, specialist help is available.

The Law Society of Scotland can provide details of solicitors experienced in employee-ownership. **Please email lawscot@lawscot.org.uk or call 0131 226 7411.**

Free guidance is also provided by Co-operative Development Scotland (CDS). CDS offers a free Employee Ownership Feasibility Study. Should you decide to proceed with employee ownership, CDS can help you choose experienced advisers and provide grant support for advisory work.

For further information, follow CDS on Twitter @cdscotland, see www.cdscotland.co.uk or call 0300 013 3385.

[1] The Ownership Dividend – The case for employee ownership 2018 www.theownershipeffect.co.uk

THE SCHEDULE

Important note: the information set out in this Schedule is based on the law as at 31 January 2019, and is subject to change.

Share Incentive Plan (SIP)

Under the Share Incentive Plan (SIP), employees can obtain shares in three main ways:

- **Purchase** – employees may buy Partnership Shares out of their gross pay, with full income tax relief. For example, an employee investing £1,000 of their pre-tax pay in shares in their employer company will not have income tax or National Insurance deducted, so they will have shares worth £1,000 allocated to them. If instead they simply took that £1,000 as part of their normal pay, they'd receive a cash amount after deduction of tax and National Insurance.
- **Gift** – employees may be allocated Free Shares, without having to pay income tax or National Insurance on the shares' value.
- **Matching** – employees may be allocated up to two Matching Shares free for every one Partnership Share they agree to buy – again without being required to pay income tax or National Insurance on their value.

Also, dividends paid on any of these shares can be paid as additional shares (Dividend shares) instead of as cash, in which case they won't be subject to income tax.

Any growth in value of the shares between acquisition by the employee and sale is free of CGT.

When and how are the shares allocated?

- **Partnership Shares** – can be allocated just once, once a year, or every month. Alternatively, employees can have Partnership Share money deducted from their pay once a month for up to twelve months (an Accumulation Period). This money is then used to buy Partnership Shares at the lower of share value at the beginning and end of that period. This transfers the risk of downward share value movement over that period from employees to the company.
- **Free Shares** – can be allocated whenever the company wishes, so long as within the annual limits (see below).
- **Matching Shares** – will be allocated at the same time as the Partnership Shares to which they relate. They must always be purchased by a SIP trust – using each employee's money if they are Partnership Shares or the company's money if they are Free Shares or Matching Shares – then immediately allocated to the names of participating employees.

Are there any conditions?

- It's an all employee plan, so everyone must be invited to participate, although the company can require employees to have worked for at least (broadly) eighteen months.

- Any shares allocated to employees must be held on their behalf in a special SIP trust – normally for five years

There are a number of other conditions.

Benefits for the company

In addition to the intended benefits for the company's performance:

- The company doesn't have to pay employer's National Insurance contributions on any pay used by employees to buy Partnership Shares so long as they are then left in trust for the full five years – saving the company up to £138 for every £1,000 invested by employees.
- The cost to the company of providing Free Shares or Matching Shares is deductible against corporation tax.
- Any award of Free Shares may be linked to achievement of performance conditions, which can be company-wide or linked to a particular business unit.
- Free Shares or Matching Shares can be forfeited if employees leave as "bad leavers" (dismissal or voluntary resignation) within three years.

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Can a company choose which employees may participate in a SIP?

No, the SIP is an all-employee plan, so it must invite all employees to participate, or all employees who have worked for the Company for a specified minimum period (which can be set at up to eighteen months).

Annual financial limits

- **Partnership Shares** – £1,800 or 10% of salary (whichever is lower).
- **Free Shares** – £3,600.
- **Matching Shares** – up to twice the number of Partnership Shares.

SAYE options

SAYE options allow UK employees to acquire shares through the grant of share options without having to pay income tax or National Insurance (NI) contributions on their option gains.

How do they work?

Imagine that a company wishes to offer each of its employees a share option. This allows the employees, after a fixed period of time, to buy a fixed number of shares at today's share value (£1.25 per share) or at a discount of up to 20% on that price (£1 per share).

- The company decides to grant the option with a £1 so-called "exercise" price.

- Each employee will only be granted the option if they agree to save a fixed amount per month for a minimum of three years, so that the total of their savings (and any interest) will provide enough money for them to exercise their option.

- For example – an employee decides to save £100 per month for three years. After three years, this will give them £3,600 (plus interest in times of higher interest rates). The employee is granted an option to buy 3,600 shares.

- Three years later, the share price has increased to £2.50. The employee uses those savings to exercise their option in full, paying £3,600 for shares that are now worth £9,000, so making a gain of £5,400. Normally that employee would have to pay income tax and possibly NI contributions on this £5,400 benefit (even though it may only be a paper gain if they haven't yet sold the shares). However, because the option is granted under an HM Revenue & Customs-approved SAYE scheme, no tax is in fact payable.

So is it completely tax-free?

No, if the employee we've just described sells the shares – which they might do either immediately or after some time – they'll then have to pay CGT on any gain made up to the point of sale. But it will often be much better to pay CGT than income tax or NI contributions, because:

- There is an additional tax-free slice – £11,700 for 2018-19.
- CGT is payable at 10% or 20%.
- Unlike income tax or NI, CGT is due only when someone sells their shares, and so when they have some cash to pay the tax bill.

What happens if an employee does not want to exercise their option?

There is no obligation to exercise the option that has been granted to them, and it would be unusual to do so where a share value had fallen below the option exercise price. If the option isn't exercised, the employee may simply keep the savings.

Can a company choose which employees get SAYE options?

No, SAYE is an all-employee plan, so it must invite all employees to participate, or all employees who have worked for the Company for a specified minimum period (which can be set at up to five years).

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Are there any limits?

The maximum monthly savings allowed per employee is £250. The savings period can be either three or five years. The option period is the same as the savings period. In all cases, the option can be exercised within six months of the end of the option period.

What happens to leavers?

Any employee who leaves due to redundancy, injury, disability or retirement must be allowed to exercise a proportion of their options – linked to the amount saved so far and any accrued interest. Any option gains are not subject to income tax or National Insurance.

Benefits for the company

Apart from the potential business benefits of a carefully designed SAYE plan – like employee motivation, creating a sense of ownership and commitment – there is also a tax advantage for the company. Any gains enjoyed by employees can be treated as an expense of the employer company for corporation tax purposes.

Company Share Option Plan (CSOP)

The Company Share Option Plan (CSOP) allows UK employees to participate in share options without having to pay income tax or National Insurance (NI) on their option gains.

How does it work?

Imagine that:

- Your company grants an employee an option, under which – after three years – they can buy 10,000 shares at today's share price of £3 per share.
- Three years later the share price has increased to £5. The person decides to exercise their option in full, paying £30,000 for shares that are now worth £50,000.

Normally, an individual would have to pay income tax and possibly NI on the £20,000 gain (even though it may only be a paper gain if they haven't yet sold the shares). However, if the option is a CSOP, they won't have to pay tax and possibly NI contributions, so long as (normally) at least three years and no more than ten years pass before they exercise the option.

So is it completely tax-free?

No, if the staff member sells the shares – which they might do either immediately or after some time – they will then have to pay CGT on any gain they have made up to the point of sale.

But it will often be much better to pay CGT than income tax or NI because:

- There is an additional tax-free slice – £11,700 for 2018-19.
- CGT is payable at 10% or 20%.
- Unlike income tax or NI, CGT is due only when the employee sells the shares, and so when the employee has some cash to pay their tax bill.

Are there any limits?

No employee may be granted CSOP options over shares worth more than £30,000. So in our example the individual could not immediately be granted any more options.

What happens to leavers?

Normally, if CSOP options are exercised within three years of grant, the employee will pay income tax and possibly NI contributions on their option gains. However, this does not apply to employees leaving for redundancy, injury, disability or retirement. An employee can also be required to forfeit their options if they leave within a certain period.

Do all employees have to be offered CSOP options?

Unlike the SIP and SAYE options, CSOP options do not have to be offered to all employees, allowing the company to select employees to participate.

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Benefits for the company

As with SAYE options, apart from the potential business benefits of a carefully designed plan, any gains enjoyed by employees can be treated as an expense of the employer company for corporation tax purposes.

Enterprise Management Incentive (EMI)

EMI is a share option plan targeted at key employees of smaller companies.

Companies who qualify

- EMI is for smaller companies only
 - with gross assets of no more than £30 million and fewer than 250 full time employees.
- Companies running certain businesses are excluded.
- The company must be independent
 - it must not be a subsidiary of, or controlled by another company (a similar rule also applies to SIP, SAYE and CSOP).
- The company must operate in the UK.

Do employees qualify?

Any employee who is to participate must work for the company for at least 25 hours a week, or if less, for at least 75% of their working time. Anyone holding 30% or more of your company's ordinary shares is not eligible.

Are there any limits?

- Options may not be granted over shares with a total market value of more than £3 million (measured at the time each option is granted).
- There is a limit of £250,000 for each employee (the value of shares when options are granted).

Tax treatment

Assuming the option exercise price doesn't exceed the market value of the shares at the time of option grant:

- There is no income tax or National Insurance payable on the difference between the value of the shares upon exercise – so if the exercise price is set at market value on the date of grant, no income tax or National Insurance liability arises.
- If the option exercise price is less than market value on the date of grant, income tax (and possibly National Insurance) will be payable on exercise, on the difference between the exercise price and market value on date of grant.

- When shares acquired through exercise of EMI options are eventually sold, CGT will be due on option gains (the difference between exercise price and sale price). Entrepreneurs' relief may be available, resulting in a 10% tax rate.

What could affect the tax treatment?

If certain things happen between option grant and exercise so that the options cease to qualify under EMI, income tax can become payable on gains up to the date of exercise.

The main disqualifying events are:

- The company becoming controlled by another company.
- The company's trade no longer qualifies.
- The option holder ceases to work for the company or for sufficient hours a week.
- EMI options are granted over shares with a value of more than £250,000.
- Certain changes or made to the rights of the shares over which the options have been granted

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What happens to leavers?

Leavers can be allowed to exercise their options without tax penalty, or can be required to forfeit their options.

Do all employees have to be offered EMI options?

Like Company Share Option Plan options, EMI options don't have to be offered to all employees – allowing the company to select which employees participate.

Benefits for the company

As with SAYE and CSOP options, apart from the potential business benefits of a carefully designed plan, any gains enjoyed by employees can be treated as an expense of the employer company for corporation tax purposes.

Employee Trust

What is an employee trust?

Employee trusts are discretionary trusts. This means that the person(s) operating the trust (**trustees**) hold property (typically shares and/or cash) on behalf of a group of individuals (employees, or employees plus former employees and close relatives of deceased employees or former employees) (**beneficiaries**). The trustees will have discretion regarding how beneficiaries benefit from the trust,

An employee trust can be a very useful and practical way of transferring ownership of a company to its employees. The trust is a single purchaser and so it is possible to avoid the need for multiple share transfers from sellers to individual employees. Also, it is significantly easier to arrange finance for a trust rather than for multiple individual employees.

Once established, the trust will be fully independent of the company.

Any cash, shares or other property held by the trust is its property, not the company's.

This means that all decisions are made by the trustees. For example, any decisions on whether the trust should purchase/subscribe for shares, sell shares or grant options over them to named employees of the company must be made by the trustees. They will take the wishes of the company into account but are never legally obliged to comply with those wishes. However, their independence does mean this can never be guaranteed.

Purpose

It is important to be clear from the outset as to what the purpose of the trust is intended to be, to ensure that it will meet your objectives. For example, will the trust:

- Acquire shares, then intend to pass them all to employees; or
- Acquire shares and retain them on a permanent basis; or
- Acquire shares, retain some and pass the others to employees.

Taxation

If the company is a close company (controlled by five or fewer shareholders) a gift from the company to the trust could give rise to an inheritance tax charge. This will not arise if the trust is not able to provide benefit to any shareholder holding 5% or more in the company (but benefits subject to income tax are allowed). If the company is close and it is intended that any person holding more than 5% of the company (including their associates) is to receive benefit from the trust, this will need to be considered carefully (see below).

Gifted contributions by a company to an employee trust will generally only be deductible against corporation tax to the extent that the trust uses the funds it has received to create an income taxable benefit for employees.

If located in the UK, the trust will be liable for CGT on any chargeable gains it makes on disposals of shares, although in some circumstances this can be eliminated or mitigated. It will also be liable for income tax on dividends and other income (not including gifted contributions under HMRC policy or loans). In a limited number of cases, it may also be liable for inheritance tax, although it will normally be an objective in establishing the trust to ensure no such liability arises. If it purchases shares, the transaction will be subject to stamp duty at 0.5% unless the purchase price from any given seller is less than £1,000. An employee ownership trust is a form of employee trust.

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Establishing and funding a trust

An employees trust can be established by preparing a trust deed which is then signed by the company and the chosen trustee(s), normally with a small initial payment from the company as the trust's first trust capital. There are likely to be associated tasks such as arranging trust finance, considering who may be beneficiaries, sourcing shares to be acquired by the trust etc.

If the trust is to purchase/subscribe for shares in the company, it will be important to confirm how the trust is to be financed. The main choices are likely to be:

- Gift from the company (in which case please note that such gift will only be deductible against corporation tax to the extent it is applied by the trust in providing a taxable benefit to a beneficiary or in enabling a beneficiary to make share option gains or other financial reward through shares);
- Loan from the company (in which case please note that if the company is a close company it will be required to lodge with HM Revenue & Customs 25% of the loan until repayment, such loan being regarded as a distribution until repayment);
- Loan from a third party such as a bank.

Accounting

Accounting for employee trusts is governed by Financial Reporting Standard (FRS) 102. This treats certain employee trusts as vehicles for employee remuneration and in those cases this has an impact on the accounting treatment. However, where an employee trust holds a long term and strategic shareholding, particularly where this is a majority holding, an alternative and simpler accountment treatment may be appropriate.

CGT relief on sale of shares to an EOT

In order to qualify for this tax relief, an employee trust must satisfy the following conditions:

- The company whose shares are transferred must be a trading company or, where there is a group, the principal company of a trading group.
- The EOT must meet the "all-employee benefit requirement", also known as the "equality requirement" – any benefit to employees must be on the same terms for all eligible employees. So the trust cannot skew benefits to the advantage of particular employees, but it can allocate benefits of differing amounts according to factors such as salary and length of service.

- The EOT must not hold a "controlling interest" in the company (i.e. more than 50% of ordinary share capital) before the transfer, but must hold a controlling interest at the end of the tax year in which the transfer takes place.
- Where the transferor has an interest of more than 5% in the company in the 12 months before they transfer their shares to the EOT, the ratio of employees who held 5% or more of the Company to employees generally must not have exceeded 2/5 in that period (i.e., 40%).

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Income tax relief on employee bonuses

The requirements for this relief are analogous to the requirements of the first EOT relief:

- The employer must be a trading company or a member of a trading group.
- The bonuses must be distributed in accordance with the all-employee benefit requirement.
- The EOT must hold a “controlling interest” (>50%) in the company (or, if there is a group of companies, a controlling interest in the principal company).
- The company must not have a ratio of office holders and directors to employees of more than 2/5 (i.e., 40%).

There is a maximum limit of £3,600 in bonuses per employee per year, it must not consist of normal salary, and must not be made by a service company.

Is everything an employee ownership trust does completely tax free?

No – the exemptions only relate to CGT and income tax, respectively. So, for instance, the trust will still have to pay stamp duty on the purchase of the shares, and National Insurance contributions will still need to be made in respect of any bonuses. However, provided that all of the requirements have been properly

complied with, the CGT liability for those selling to an employee ownership trust (or, as the case may be, income tax on employees receiving bonuses from a company controlled by such a trust) should be reduced to zero.

What could affect the tax treatment?

The legislation contains anti-avoidance provisions which will withdraw the CGT relief if the main conditions cease to be satisfied before the end of the tax year following that in which the EOT acquires its shares. They also impose a CGT liability on the trust where the conditions cease to apply at any later date.